THE BUSINESS CORPORATION

Its Financial Organization and Operation

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To

THE GRADUATE STUDENTS IN FINANCE
of the Wharton School
and
THE MEMBERS OF THE FINANCE SEMINAR
of the
EVENING SCHOOL OF ACCOUNTS AND FINANCE

This Book Is Appreciatively Dedicated

Preface

Over the years the corporation has become the most serviceable device for the conduct of business enterprise. In a capitalistic economy it offers advantages superior to any other form of business organization. As the size of the business unit has increased, the corporation has grown apace until today it stands supreme, employing more people, producing more goods and contributing more income to investors and to the state than any other form of business organization. Changing conditions have affected not merely the size of the corporation, but also its structure and the various uses which are made of it in the conduct of business enterprise Our purpose in offering the present volume, which takes its place among so many books dealing with the subject, is to emphasize the changes in corporate structure, practice and regulation which the last ten years have introduced. In developing the subject we have adhered to the original plan of *Corporation Finance* (originated in 1910 by one of the authors[1]).

This plan followed the line of the corporate life cycle from birth, through growth to maturity, to decay and death. To carry the analogy further, our treatment may be likened to a discussion of the anatomy, physiology and pathology of the corporation, treating it as a living organism composed of human beings, and following in its life cycle the phases of human existence.

In treating each phase of the subject, we have given first consideration to the attainment of the fundamental corporation objective of a continuing profitable existence. When this is no longer possible, an equitable settlement and winding-up of its affairs must be obtained.

Among the outstanding characteristics which differentiate the treatment of corporation finance in this volume from that followed by other discussions of the subject is the detailed consideration of the place, scope and dangers of corporate borrowing and the general reduction in recent years of the use of this form of financing by many of the largest and most successful companies. The growing importance of corporate regu-

[1] *Corporation Finance* (D Appleton and Company, 1910), by E S. Mead

lation is adequately recognized in the analysis of the recent control measures which aim to protect the investor and so to increase the usefulness of the corporate device.

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THE BUSINESS CORPORATION

CHAPTER 1

INTRODUCTION

In the industrial and social history of the United States from 1890 to the present time, we find a vast and almost universal revolution in consumption and in production. In diet, clothing, housing, education, communication, amusement, travel and transportation, books, newspapers—in every department of consumption—we find this bewildering kaleidoscope of incessant change. Let us, by way of summary illustration, take companies listed on the New York Stock Exchange, divided by groups according to their principal line of business, and separate those which have reached maturity from those which are still in the development stage. The list of industries developed during the last fifty years is long Fruit and vegetable packing, automobile manufacturing, automobile accessories (thirty-six large companies), the radio, chemicals, soft drinks, motion-picture, bus and taxi-cab operation, business machines (with the exception of typewriters), hard-surfaced floor coverings, confectionery, dairy products, drug chains, food chains, restaurant chains, department store chains, variety chains, drugs and proprietary medicines, domestic electric appliances, heavy electrical machinery, electric power and light, glass containers, instalment financing, steam laundries, motion-pictures, radio, gasoline, paper specialties, domestic powered accessories and sanitary plumbing.

In the field of capital goods, with which and from which these manifold goods and services are produced, we find the same sweeping changes and improvements. In power, for example, one pound of coal produces one kilowatt-hour compared with ten pounds of coal to one kilowatt-hour forty years ago We have the development of new sources of power—gasoline, fuel-oil, water-power, new forms of power distribution and new mechanisms of power production, as well as new material for the construction of power machinery. In the field of synthetic products, we have rayon, nylon, plastics, synthetic building materials, camphor, alcohol, acetic acid, sulphur, nitrates, rubber, and perhaps eventually, sugar. A large variety of new alloys have entered to prolong

the life of metals, and to increase their tensile strength and resistance to acid and weathering.

In transportation, we have the motor truck, 800,000 of them in 1940 in the United States alone We have power-driven canal and river boats, Diesel electric-motor ships, and pipe-line transportation of gasoline. We have airplanes with cruising speeds of 250 miles per hour, with the establishment of air express lines and regular transoceanic service. We have the supplementing of the surface street-railway by the subways. We have steel building construction, starting about 1890, which has been responsible for the modern sky-scraper city.

Comparative Rate of Industrial Improvement

These are only a few of the many changes in consumption and production during the last fifty years The half-century preceding—from 1840 to 1890—displayed no such number of industrial developments. The railroad, the beginnings of electricity and gas, the Bessemer steel process, chemical dyes and the development of agricultural machinery, are the most important discoveries in the era 1840 to 1890 The half-century before 1840 showed far less change The marine steam-engine, the development of metal-working tools, and the railway locomotive were the most important.

In the eighteenth century, aside from the beginnings of the steam-engine and the textile inventions, industrial growth proceeded at a snail's pace Fifty years came between the Newcomen engine and Watt's condensing engine. Twenty-five years were required to make the steam-engine commercial, and thirty years more to apply the steam-engine to the railway. All these rates of progress are slow—almost glacier-like—not to be compared with the rapid changes, the instantaneous transformations of the age of electricity and synthetic chemistry. The radio was brought to approximate perfection in five years, the automobile was doubled in effective value in ten years; the efficiency of the steam boiler has been increased 75 per cent since the Great War; the cruising speed of the airplane has tripled in the same period.

Of especial interest to the new generation, the achievements of the past twenty years in diversifying and cheapening the necessities and comforts of existence, luxuries of the past are now comforts, are likely to be far surpassed by the achievements of the next twenty years. Indus-

trial advance is cumulative. It builds upon what has gone before Watt builds on Newcomen, Fulton applies Watt's invention to the ship, Stephenson applies it to the rails, Edison takes off from Davy's and Faraday's work in the laboratory, Dorrance develops the Campbell Soup Company out of Liebig's work in the chemistry of foods, Ford improves the internal-combustion engine and adapts it to the motor-car; the Duponts develop the technique of explosives manufactured into a large number of synthetic products, Herty utilizes yellow slash-pine as a raw material of paper, on the basis of his knowledge of the composition of spruce-wood pulp.

Past Accelerates New Developments

The improvements and inventions, the new products and services which await discovery and development, as well as the increase in production of existing goods and services, are accelerated by the achievements of the past. Air-conditioning—manufactured weather—is in its infancy. The entire field of living and working space lies open to its exploitation. The low priced airplane is here. It promises mass use of air transportation. The limitless energy of atomic disintegration has at last been unlocked for development While the automobile, the radio, the movie, and the newspaper are the possessions of almost every one, even the poorest, many of the comforts of living are still unavailable to the low-income groups. Cheap, comfortable houses, sanitary plumbing, central heat and refrigeration, house insulation, mechanical stokers for cheap fuels, indirect lighting, cheap, durable, and artistic furniture; hard-surfaced floor coverings—all these are still the possessions of the minority of the 30 per cent of American families with incomes of $1500 and upward. Higher education, the opera, the orchestra, magazines and books, travel, modern medical and surgical attendance in illness—most of the wide field of civilized living—is still waiting to be developed for the masses. That these possibilities can be realized, there is no doubt. Their realization goes on before our eyes. The advertising pages of magazines are filled with the results of these improvements and discoveries, always forcing new products and services on the attention of the consumer, and creating new profits and values out of a constantly expanding volume of sales.

The novelties of to-day become the familiar necessities of to-morrow, to be in turn displaced by the developments of to-morrow-week.

The Capitalistic System

This summary view of the achievements of the past and the opportunities of the future, presupposes a continuation of the economic structure in which the capitalistic system rules. The outstanding characteristic of the capitalistic system is the opportunity it gives to individuals to improve their condition. The industrial nations of Europe, and the United States abound with illustrations of men who, starting with nothing, by successful investment, attained enormous wealth. A partial list of the United States alone is impressive.

Cornelius Vanderbilt
Jay Gould
Collis P. Huntington and his associates
James J Hill and his Canadian associates
E H. Harriman
Andrew Carnegie and his partners
Philip D Armour and the meat-packers of his generation
William Weightman
John D Rockefeller and his associates of the Standard Oil group
Henry O Havemeyer
George Hearst
P. A. B. Widener
William Elkins
Thomas Dolan
Mark Hanna
George Eastman
Adam Gimbel
John H. Patterson
Cyrus McCormick
William Wrigley, Jr.
Joseph Pulitzer
Julius Fleischman
John B Stetson
William B. Thompson
Joseph Wharton
F. W. Woolworth
John and James Dobson
the Dodge Brothers
Asa B Candler
the Du Ponts
the Guggenheims
Marshall Field
Julius Rosenwald
R J Reynolds
James B Duke
George F Baker
Henry Ford
John Wanamaker
William C Whitney
George M Pullman
Thomas F Ryan
John T. Dorrance

These are among the conspicuous illustrations of great wealth achieved by men who had the courage to risk their savings and their time in the development of new enterprises.

In each of these cases, the start was the same, the investment of a comparatively small amount by the enterpriser, and his associates, in the development of a new business opportunity which yielded large profits—the original Southern Pacific group started with $100,000 earned in the mercantile business--the Ford Motor Company started with $25,000 cash capital The reinvestment of these profits in expansion, and the addition of new capital as earnings made this course possible, while the original group retained control. Keen, shrewd, thrifty business management sometimes sacrificed everything to the main chance. It was not, in many cases, over-scrupulous in laying hands on property to which others might have set up claims, but the result of its activities was a general increase in the comforts of living, a substantial rise in the standard of subsistence This sequence of events characterizes the early history of almost every successful business in the United States. It may be taken as furnishing the pattern of promotion and development.[1]

Example of Growth under Capitalistic System

The process may be exemplified by the growth and development of the Carnegie Steel Company The business had its beginning in 1858, operating as a small forge owned by Andrew Klowman and his brother, Anton, who placed a value of $4800 on their good-will and stock A year later, through the making of an additional investment of $1600, the business was expanded to meet a rapidly growing demand for its product. In 1862 a new and larger mill was made necessary for further growth of the business, and to meet this situation the firm was organized. New articles of partnership were drawn in which it was stated that the capital should be $80,000, to be paid in from time to time as the needs of the business might demand.

In 1863 the development of a disagreement among the partners presented the occasion for Andrew Carnegie to enter the steel business, his

[1] Under the present system of income taxation, which takes 73 per cent, and in New York 79 per cent, of the highest incomes, it is no longer possible for a rich man to retain and increase in productive employment the large income which his industries earn for him Neither is it possible for him, in the face of very high inheritance taxes, to pass on more than a modest fraction of his accumulation to his heirs He must leave his profits in the business which creates them, foregoing a large part of his dividends and retaining, not selling, his stock If, like the late Andrew Mellon, he wishes his heirs to retain control of his property, he must set up public trusts, of which they may be custodians, but whose income is devoted to the public welfare

services being sought as a peacemaker. At this time, Carnegie was twenty-eight years of age. He had made a little money through the aid of Thomas A. Scott, an official of the Pennsylvania Railroad, who had given him an interest in the Woodruff Sleeping Car Company, and the Columbia Oil Company. This meager beginning was the basis of his fortune. The restoration of peace among the partners of the business was brought about in 1863. A new partnership agreement was drawn up, in which the capital stated was $60,000. Mr. Thomas Carnegie was admitted to this association with money provided by his brother, Andrew, and it was in this way that the Carnegies went into the iron business.

Andrew Carnegie, in 1864, allied himself with Thomas N. Miller, who had been expelled from the partnership, in the development of a rival enterprise, named The Cyclops Iron Company. The building and equipment of this company were found too weak to be operated with safety. At the beginning of 1865, the capital of the original association was raised from $60,000 to $150,000 in order to keep pace with its earning power. Due largely to the persuasive powers of Thomas Carnegie, an agreement was concluded whereby Andrew Carnegie and his associates in The Cyclops Iron Company turned over the property of this business, together with $50,000, to the old organization, in exchange for slightly less than one half of the shares of a new and third company, the Union Iron Mills Company, organized with a capital of $500,000 By 1867, Andrew Carnegie succeeded in acquiring 39 per cent of the outstanding shares of this enterprise.

In 1873, the original plant was sold in order to effect economies in the operation of the other properties. Andrew Carnegie contributed as a silent partner $60,000 to the capital of the firm of Wilson, Walker and Company, which was formed to acquire the property. By 1881, when Carnegie Brothers and Company, Ltd, was created to effect the consolidation of various properties, the Union Iron Mills Company was valued at $630,000, which, together with the price of $230,000 obtained for the property sold, indicated a value of $860,000. Apparently the plant had increased 72 per cent in value in sixteen years. The new firm, Carnegie Brothers and Company, Ltd, had a capitalization of $5,000,000, and the interest of Andrew Carnegie amounted to $2,737,977 95.

In 1882, Henry Clay Frick admitted the Carnegie interests into his

business of producing coke, and allied himself with the steel industry. This connection was followed in 1883 by the acquisition of the Pittsburgh Bessemer Company, Ltd., which had been developed as a competitor, but which was forced, due to labor trouble, to discontinue, and in 1890 by the acquisition of the Duquesne Steel Company. On July 1, 1892, the separate establishments comprising the Carnegie interests in the steel industry were brought into a single organization They were consolidated into the Carnegie Steel Company, Ltd., which had a capital of $25,000,000.

The next move was the acquisition of a supply of iron ore. A five-sixth interest was obtained in the Oliver Mining Company, capitalized at $1,200,000. Finally the Pittsburgh, Bessemer and Lake Erie Railroad, and the Pittsburgh Steamship Company were purchased, and the integration of the business was complete. In 1900, through the formation of the Carnegie Company, with a capitalization of $320,000,000 divided equally between stocks and bonds, all the stocks of the Carnegie Steel Company, the H C. Frick Coke Company, and their subsidiaries, were brought under the control of a single corporate owner. This vast industrial empire, which provided the foundation of the United States Steel Corporation was created almost entirely by the reinvestment of profits Between the years 1875 and 1900, the aggregate net profits of all the Carnegie associations amounted to $133,391,005.41, of which amount nearly $40,000,000 was made in 1900.[2]

Recent Promotional Activities

A mistaken idea prevails in many quarters—and how mistaken the idea is, we have endeavored to show—that the door of opportunity is now closed to the ambitious youth of America, that the achievements of Carnegie, Frick, Ford, and others are no longer possible.

Thirteen years ago a mechanic in Philadelphia, whose name we have no authority to use, invented a piece of equipment in which he had great confidence. He succeeded in communicating his own belief in his invention to two of his friends. One of them subscribed $10,000 and received 40 per cent of the stock of the company organized to develop the invention, and the other subscribed $5,000 and received 20 per cent of the stock. The inventor retained 40 per cent and assumed the responsi-

[2] James Howard Bridge, *The History of the Carnegie Steel Company* (Aldine Book Company, 1903).

bility of development and management. He equipped a small shop and started manufacturing. As usually happens in such cases, the $15,000 soon disappeared. Sales were few, although prospects were bright. The device had great merit and was slowly making its way. The 40 per cent cash subscriber became dissatisfied with the slow progress of the business He insisted that the inventor-promoter should raise the money elsewhere and buy out his interest This, by some miracle of negotiation, the promoter succeeded in accomplishing He borrowed $10,000 on the security of 80 per cent of the stock of the company, and paid off his dissatisfied associate. Within thirty days after this purchase, he made contact with the research department of a very large corporation interested in the same line, and sold the patents covering his invention for $250,000 cash. In addition, the large company organized a subsidiary company with $500,000 capital, gave him an option on a substantial amount of stock in this company and an executive position, entrusting him with the work of organization and further development. The associate who, perhaps because of indifference or carelessness, retained his interest, received $50,000 in cash for his $5,000, and the one who withdrew lost $90,000 for his caution. The promoter-inventor, who put up nothing but his own time and energy, received $200,000, plus the other emoluments mentioned.

This experience can be duplicated in many new industries The inventor of the autograph camera received $50,000 from the Eastman Kodak Company.

The careers of William Fox and Samuel Insull, although ending in clouds and gloom, furnish additional information within recent times that the door of opportunity is not closed, and that ability and energy, supplemented by the gift of constructive imagination, and starting with a small capital, can still, in spite of the growing exactions of taxation, produce very large returns Each of these men was at one time extremely wealthy. Of course, Ford, measured only by the pecuniary standard, is the outstanding business genius of all time, and in 1903 he walked the streets of Detroit, by his own statement, seeking credit for a Christmas turkey

In the income-tax returns for 1929, 513 persons reported incomes of $1,000,000 or more. Five hundred and thirteen million dollars of income (of course the average income was in excess of $1,000,000) capitalized at 5 per cent, represents a principal sum of $10.26 billion. In the first

year for which income tax returns were reported (1914), the number of "millionaires" was 60

On the other hand, against these records of success, a very large amount of money has been lost, no one knows even approximately how much, in the attempt to develop new enterprises Since the beginning of the automobile, there have been over 1300 different makes of cars put on the market, most of them by separate companies Nearly all of these companies were liquidated or absorbed by the survivors Most of them failed Nearly all the business is now in the hands of three large companies The smaller companies that still survive are living in the shadow of General Motors, Chrysler, and Ford. Doane, in his book, *The Measurement of American Wealth*, estimates that over a series of years the losses of business approximate the profits. John D. Rockefeller, Jr, in one of his rare flights of poetic fancy, attracted much critical attention by comparing the growth of the Standard Oil Company to the efforts of a gardener to develop the perfect rose by gradually eliminating a large number of roses which could be dispensed with. While the illustration, from the standpoint of the Rockefeller's public reputation at that time, was unfortunate, it describes what has gone on in every line of business. The waste can be described by no milder word than terrific. The money sunk and lost in railways, coal-mines, lumber, metals, oil-well developments, precious-metal experimentation, and manufacturing of all kinds is beyond calculation

Pattern of American Industrial Development

Industrial development in the United States has followed the experimental method. It has fitted itself to the speculative pattern. Where untried fields were invaded by inexperienced men with other people's money obtained by the promise of abnormal dividends, the result was a large percentage of failures If the community desired that large risks should be taken in the exploitation of its resources, that each phase of its industrial development should be carried through with a haste and fury which leaves far behind the slow judgment of the investor, if railroads were to be pushed out hundreds of miles into deserts, and if thousands of oil-wells were to be drilled on the strength of a few gushers, then heavy capital loss was inevitable Every discovery of mineral wealth was a signal for the expenditure of millions of dollars, much of which was lost.

Whether this method will continue for the future we do not know. As will appear in later pages, the public authorities, through Blue Sky laws, Security and Exchange Commissions, Public Service Commissions, and the constant pressure of the organized exchanges, are endeavoring to reduce the risk in new business enterprises. Up to the present time, it can not be said that their combined efforts have been successful. All that they have done is to force upon the speculative promoter who uses other people's money, a measure of candor in the disclosure of the facts upon which his proposition is based

It is the purpose of this book to describe the development of business enterprises from their small beginnings to their mature size and final decay, to show how they are started, how their initial capital is provided, upon what financial plan their capital structure may be raised, and the principles applied in determining the type of financial structure; to show how corporation securities are marketed, to explain the outstanding internal financial problems of corporate management; to develop the commonly used methods of financing corporate growth or expansion, the objective sought, as well as the methods used in consolidation and combination, and finally to present a detailed description of financial readjustment, reorganization, and liquidation of business corporations.

CHAPTER 2

STARTING A BUSINESS ENTERPRISE

A business enterprise is not the result of spontaneous generation Certain factors of production must be brought together These factors are capital and management. Their co-existence at a given time and place presupposes human ingenuity This process is promotion The elements of promotion are four discovery, investigation, assembly, and financing. The promotion of every business enterprise has taken these four steps, although not necessarily in the order named Assembly sometimes precedes investigation Financing may directly follow discovery, leaving assembly and investigation to a later time But, in one order or another, the promotion of every business enterprise contains these four elements.

Take them up in the order named Discovery is the recognition of the profit-making possibilities of a business enterprise. An invention, a deposit of minerals, a demand for real estate, the consolidation of two or more existing enterprises, the purchase of a going concern from its owners or creditors—all the manifold forms which business enterprise may assume, fall into three grand divisions, first, a new project, product, machine, process or institution, second, a duplication of an established business in a new location, third, expansion of an established business or the creation of a new business out of existing concerns by consolidation or reorganization These include every form of new business enterprise which can engage the attention of the business promoter

Discovery of a Business Opportunity

A business opportunity must first be discovered by some Columbus before it can be assembled and developed In a world of incessant change, full of men blessed with insatiable curiosity and plentifully endowed with the instinct of acquisition, opportunities to make money are constantly being unearthed, studied, and urged upon the attention of those who can furnish the money to develop them The inventor is the first of these pioneers. Over two million patents had already been

granted in the United States by 1937 Many of these patents are assigned when issued These are the work of the research organizations of existing companies Their inventors, who are salaried men, usually have no pecuniary interest in the exploitation of these ideas

More numerous are the independent inventors who arrive at a new idea in some such way as James Watt recognized the principle of condensing steam within the cylinder, by a flash of intuitive reasoning in the course of a Sunday evening's stroll, or by accident, as when Goodyear threw a piece of rubber across his work shop, despairing of being able to do anything with it, to find it several days later in its position on the stove lid, vulcanized, or the common type of inventor who reaches his goal at the end of a long series of experiments by the method of trial and error, as with Hall, the discoverer of the electrolytic process of producing aluminum, or George Westinghouse with the air-brake, or George Stephenson with the locomotive exhausting into the smokestack

These inventions, the crystallization of ideas into workable projects, if they have any value, must be patented A patent is an exclusive grant for seventeen years, from the United States Government, to manufacture and sell the subject of the invention, machine, product, or process. This patent, which any inventor can obtain upon application and proof of priority of discovery, may or may not have value Whatever value it has depends upon (a) the commercial importance of the invention and (b) the result of litigation in the Federal courts. Until the courts have passed upon the priority and originality of an invention, it has only a putative value, a *prima facie* claim to consideration. Unlike the decisions of the Interstate Commerce Commission which are conclusive as to the facts, in patent cases, the court passes on the facts and the law.

The Patent as a Basis for a New Enterprise

Without some kind of patent, no matter how flimsy its claims may be, it is difficult for an inventor to gain a foothold in an enterprise organized to exploit his ideas The patent is the inventor's starting point. With this he can get a seat at the conference table and, if only on the basis of a nuisance value, bargain for a share of the profits. Without a patent, unless he possesses special knowledge indispensable to the new enterprise, he is not seriously considered

There are two methods by which patents can be marketed. The first

method is to sell the patent to an established institution. Any company is in the market for any patent which, in the opinion of its technical experts, has substantial value to its business. The price is subject to negotiation. Sometimes very high prices are paid. Professor Pupin received from the American Telephone and Telegraph Company $500,000 for his loading coil invention, by which he applied Lagrange's equation of the loaded string to the electrical circuit. Another example of the occasional high price of a patent, which came out in litigation, is that of the company manufacturing the Van Huesen Collar, which, it was stated, paid the inventor after litigation $1,000,000 damages for infringement. The inventor of the Hering Electric Roasting Furnace, in large use in the copper-smelting industry, after prolonged litigation which was financed by a corporation organized for the purpose, collected a huge sum in damages. It is impossible to compile any complete record of the prices paid for patents. These prices are almost invariably confidential. In the same way, the royalties received by patentees are not published, but, in many cases, they are large.

The natural purchasers of patents of proven value are existing companies able to put the invention into commercial use. The wise inventor takes the cash and goes on to new discoveries. But many inventors are not wise. They look about for capital to develop their invention in which they see, with the eye of faith, uncounted millions of profits. The great obstacle to most inventors in promoting their inventions, is a form of unreasoning avarice which seems indigenous to the species. The inventor (and while this statement is not capable of statistical proof, any one who has had to do with inventors can vouch for its truth) is likely to be unreasonable in his opinion of the compensation which he should have for his invention. He usually places an extravagant value upon it, and he holds to this opinion tenaciously. The following case is typical of his class. In 1899, an employee of a large railway equipment concern invented an improved draft-gear, the appliance which takes up the shock of impact when railway cars come together. His device was recognized as of superior merit by his employers, who offered him $25,000 in cash for his patent rights, with a substantial advance in salary. This offer was refused with scorn. The inventor resigned his position and spent a large part of his time for many years in unsuccessful attempts to finance his invention. He eventually sold his patent to the company which had originally offered him $25,000, for $1500.

Importance of Investigation in Promotion

Assuming that the inventor's patent can be purchased, and that he is willing to bind himself to transfer it on the payment of the consideration agreed upon, and taking the patent covering a new invention as one of the most familiar sources of new business enterprise, we have now to consider the methods employed to investigate the commercial possibilities of an invention Suppose that the patent relates to a new product or process The three steps in its investigation are first, the laboratory, second, the semi-works plant, and third, the commercial plant. These words are self-explanatory. The first step in determining the merits of a new product or process is to make or use the product on the smallest possible scale, which is the laboratory, to ascertain whether the claims of the patent are borne out in a practical test Assuming that the invention passes this preliminary inspection, the next step is to produce, either by building a small plant for the purpose, or by engaging some machinery already erected, a commercial quantity of the product, or to use the process on a commercial scale. This is the semi-works stage of the investigation. Its objects are three-fold. (1) to try out the product or process under conditions which approach the scale of commercial operation, although not to produce the product at a profit, (2) to obtain a sufficient quantity of the product to show its marketing possibilities; and (3) to demonstrate that the product, when produced in commercial quantity, will possess the same qualities as the laboratory specimen. If the product or process passes the first two stages of investigation, the third stage may be safely entered upon.

The third stage involves the design and the equipment of a plant large enough to turn out the quantity which the market investigation, to be presently described, shows can be sold It is seldom desirable to erect a building The usual plan is to rent space. If the invention does not require the use of equipment to be specially manufactured, there is no difficulty in completing this part of the investigation. The price can be quickly ascertained. Arrangements can be made with the manufacturers, either through their own organizations or through construction concerns with which they are affiliated, to install the equipment. The cost of the raw materials can be determined. The custom of the particular trade governing purchases and sales, will indicate the amount of inventory. The amount of working capital which must be provided, can

be determined. Before the creation of a commercial plant, however, or in some cases before the expense of the semi-works plant is incurred, a market survey must be made.

The Market Survey

The market survey will vary according to the class of customer, whether (1) business men, buying for their business; (2) distributors, buying for resale to retailers, or (3) consumers, buying for their individual use. The second and third classes must be considered together, since the distributor will not order what the consumer will not purchase from the retailer

All commodities may be divided into capital goods and consumer's goods. Capital goods include all raw and some finished materials or products, and the machinery and equipment with which production is carried on If the invention relates to a new raw material, it must meet the specifications built up by the experience of those engaged in the production of the existing material If the new product meets these specifications, and if it can be made and sold at a lower price than the price of the existing product, its success is assured. The market investigation is then unnecessary If, however, the new product does not meet the specifications, no matter how cheaply it can be produced, there is no place for it It often happens that business men, carried away by their rosy visions of large profits, overlook this elementary rule of sound inquiry, and put their money into schemes which the commercial laboratory, at a cost of a few hundred dollars, could have shown were worthless.

Example of Inadequate Investigation

An investment banker, through a former employee, was brought into contact with an inventor who claimed to have a product made by treating paper which was water-proof, grease-proof, oil-proof, and which could be produced with simple apparatus at low cost The commercial field for such a product is very broad. It can be used in the place of varnished paper. It can be used for all kinds of containers. It can be used for table-covers, for picnic dishes, for wall-paper, and for many types of insulation Assuming that the inventor's claims were correct, the possibilities of profit were large The banker, taking the inventor's statement at its face value, began to feed money into the

scheme. He placed the inventor on his pay-roll at a substantial salary. He furnished money for traveling expenses. He employed engineers to report on the machinery necessary to turn out the paper in quantity, he obtained estimates of the cost of plant. He explored the market, always assuming that the product would do what the inventor claimed An outsider, who was attracted to the invention because of one of its possible uses in which he was interested, finally suggested to the banker that a laboratory test be made of the paper to see whether it would meet the specifications The banker, who had already invested $10,000 in these various activities, balked at spending $150 additional to test the paper, an expenditure which he should have made in the first place. The intervener managed to secure this investigation without cost to the banker. It disclosed that the paper was not water proof nor oil-proof, in fact, that it had none of the properties which the inventor claimed for it The inventor's "free ride," as such activities are sometimes called, came to an abrupt end

Example of Adequate Investigation

In contrast with this fiasco, may be placed the experience of a large engineering and manufacturing company which proposed to place on the market a new domestic and apartment-house automatic stoker for the burning of the smaller sizes of anthracite coal. The first step was to build in the machine-shop (laboratory) *one stoker.* This was installed in the residence of the chief engineer in charge of the stoker division. Here it was operated for a year Before the next burning season, ten stokers were manufactured, embodying in their designs many changes which the engineer's experience had shown to be necessary These were placed in the houses of various employees of the company without charge, reserving the privilege of regular inspection of their performance. Various changes were made as the result of this group experience. At the same time a larger unit was manufactured and installed in a hotel. All of this deliberate and even leisurely procedure was preliminary to (1) the estimate of cost of quantity production, and (2) the determination of the number of stokers of different size which could be sold. This organization had long experience with the manufacture of stokers for steam plants Given the number of units to be sold, they could determine the cost of production and installation. The determination of the number which could be marketed now required a market survey.

Continuing our stoker illustration, we have here a device which was to be sold to the commercial user, the proprietor of a hotel or office building, or even a small factory, and, in a smaller size, to the household user to compete with the oil-burner, which, in the better-class homes, has almost crowded out the coal-burning furnace. The investigation of the market for these two types of stoker must follow different lines. The number of outlets for the large stoker in, for example, the city of Philadelphia, can be determined at the Bureau of Boiler Inspection at the City Hall, since every boiler operating above a certain pressure must have a permit. The record of these permits gives a variety of information essential in the formulation of a sales proposition. From these potential sales propositions, the volume of business can be determined.

The second point of inquiry is the type and age of existing equipment. If it is already obsolete, it will be easier to interest the owner of the building in making a substitution.

A third feature, which is even more deeply involved in the marketing of the household stoker, is some plan of installment finance. At the date of this investigation, many hotels and apartment houses were in the hands of their creditors. They had no money to invest in new equipment. If these commercial stoker units were to be purchased by this class of buyers, some long-term installment plan must be provided, so that the savings in wages and fuel could be used to meet the installment payments. In the same connection, the market survey should show the ownership of the buildings where it is proposed to sell the device. Given this information, it is possible to estimate the potential market for the commercial stoker.

When the investigator, however, turns his attention to the household market, he encounters a new set of problems. A stoker is not a necessity. It is a luxury, like the automobile or the mechanical refrigerator. The majority of homes are still heated by coal furnaces. It is only in the higher income brackets that automatic equipment is now routine installation. Like other mechanical aids to comfortable living, the stoker is moving down the economic scale, just as the automobile is not far from recognition as a necessity to decent existence. The domestic stoker has not, however, reached that position. Its field of marketing is fully occupied at present by the oil-burner. The only sound arguments in favor of the stoker are that coal is cheaper than oil, and that anthracite does

not explode, or fill the house with smoke and fumes destructive to interior furnishings

It is with the feasibility of selling the household coal-stoker that the market survey of a domestic stoker must primarily deal Can the coal-stoker, burning a low grade of anthracite, or bituminous coal, drive out the oil-burner which already occupies this field? Can the coal-stoker anticipate the oil-burner in its invasion of the homes in the lower income brackets? In Philadelphia, a percentage of new houses above the $4000 class are equipped with oil-burners at the time of construction Due to the ease with which oil-burner equipment can be fitted into coal-burning furnaces, the substitutions in existing houses of oil for coal, is going on at a rapid rate. In the country at large, 1,800,000 oil-burners were sold during 1936 The individual consumer is influenced in his choice, by a variety of motives. Some of these motives are not economic. The engineer of an apartment house would recommend the installation of a commercial stoker plant, solely on the grounds of economy and efficiency. The owner of a suburban home, or rather the owner's wife, would be little influenced by considerations of saving Prestige, the desire to emulate the owner's sister-in-law, the aversion to the dirt and discomfort of ashes and coal, the location of the fuel reservoir outside the house, the uncertainty of automatic heat control, all of which advantages must be proven in the case of coal, offer obstacles to the introduction of a device whose appeal is mainly economic.

This company made no adequate market survey. They knew that their coal stoker was mechanically perfect. They assumed that it could be sold. They spent a moderate sum in manufacturing two hundred stokers and set up a sales department. They established a few agencies. In four months they sold nineteen stokers. The enterprise was promptly abandoned.

The market survey is a preliminary essential to the development of any new product If it will not sell, it should not be produced. It is impossible to determine, in advance of extensive market sampling, that the product will sell Various methods are employed in these market surveys. The questionnaire can be used. For example, a survey to determine the market for a packaged synthetic fuel suitable for fireplaces, took the form of a canvass of a large number of houses in two suburbs of Philadelphia during the summer to determine, first, the price paid for wood with which the new fuel was to compete, second, the extent to which

the fireplace was now used, third, so far as could be determined, the attitude of the housewife toward a fireplace fuel delivered in a package ready for use. After the preliminary survey, in this instance, the next step was to sell the product without reference to its cost of production About 3000 packages were manufactured, of which 2500 were sold in a department store in New York, and 500 in Philadelphia. Although, up to this point, the investigation seemed to promise a favorable response, the reaction of the department store customers, especially from the standpoint of price, was not sufficiently favorable to warrant a continuation of the enterprise. Cost of production could not be brought within the price limit necessary to develop consumption.

Even exhaustive market surveys sometimes fail to disclose defects in the salability of the product which are fatal to its profit prospects One of the pressing personal problems of the age is the cost of silk hose This cost is doubled by "runs" in the stockings. No female of repute will risk a public appearance in stockings which show these obvious and disgraceful defects The quest for a runless stocking seemed to be successful five years ago when the "lock-stitch" stocking appeared. The process, which is described by its name, was invented, patented, and sold to two of the largest hosiery mills, who proceeded to make a heavy investment in its production This investment was preceded by a conventional market survey A sufficient amount of the new hosiery was produced to stock stores in different parts of the country. The response was favorable. The new stockings were well received by the trade. Large advance orders were obtained. On the strength of this survey, a large investment was made in equipment, materials, and wages to turn out the product in commercial quantities. For a month all went well, and then, almost overnight, the demand evaporated, and the investment was a total loss. The reason was that the new hose, while they would not run, and on that account were much more desirable than the product then used, did not have, so the customers said, the "sheen" so dear to the feminine heart. Objection was made to the "fish-net" effect of the new product, due to the method of its fabrication. The result of this business failure serves to re-emphasize the importance of careful, painstaking, deliberate investigation, characterized throughout by a spirit of intense skepticism, before launching an enterprise based upon a new product.

Factors Influencing the Investigation

The difficulties of investigation in other fields of business enterprise are not so great as where the new business aims at a new product or service When the proposition is to lower the cost of producing a product whose market is already established, or of duplicating an established business in a new location, the prejudice of the consumer, who so often does what he wants to do rather than what the producer thinks he should do, may be disregarded A new population concentration, as when a new factory employing a thousand men is located in or near a small town, furnishes a sure basis for a number of business enterprises stores, public utilities (light, water, and gas), hotels, contracting enterprises for streets and sewers and buildings, amusements, motion-picture houses and amusement parks, restaurants, local manufacturing enterprises, such as ice-plants, bakeries, laundries, and banks. These are the more important of the new business developments and enterprises which follow a new aggregation of people The basis of investigation of these business opportunities is found in the special *Reports of the United States Census*, which give, for a large number of cities and for a great variety of industries and businesses, both producing and servicing, the number of employees, the value of products, and the wages paid The census also gives the volume of sales in different parts of the country for different products From these figures as a starting point, on the basis of known facts of the neighborhood, including the per capita income which is also furnished by the federal government, the investigation can proceed to determine whether, for example, a hotel, a steam laundry, or a bakery, might succeed.

In addition to these local enterprises, the opportunities for real estate developments to furnish housing to this new population, are attractive. Here again the promoters are dealing with known quantities. The wages which will be paid by the factory are known, and the family incomes of the employees can be computed. It is known, on the basis of wide experience throughout this section, what type of house can be sold to families in this income group. The primary and secondary costs of developing such an operation—original cost of land, streets, sewers, sidewalks, etc—are known. If financing arrangements can be made, the supplying of homes to this population can be profitably undertaken In all of these developments, the investigation starts from known facts,

proceeding from the experience in this region in similar undertakings With good management and conservative capital expenditures, there is a reasonable certainty of profit

Investigation Incidental to Consolidations

Finally, we have the investigation preliminary to the formation of consolidations. Consolidation has played an important part in the development of new business enterprises, a role as important as that played by those who have originated the ideas on which these enterprises were founded A glance at the financial page of any newspaper of large circulation will show the importance of consolidation Most of the large companies whose stocks and bonds are listed, and which make up the investment holdings of the country are consolidations The Pennsylvania Railroad and the New York Central, the two largest railway systems in the country, are consolidations The United States Steel Corporation, General Motors, Chrysler, Allied Chemical and Dye, the Du Pont Corporation, General Electric, nearly all the large public utility companies, both in their local and national scope, department store chains, food chains, and the variety chains have been built up by the amalgamation of preexisting enterprises. Even so local an institution as a bank has been profoundly influenced by the process of consolidation. Such institutions as the Bankers Trust, the Guaranty Trust, the Chase National Bank, and the National City Bank, have grown to their present size in part by the absorption of competitors.

The purpose of the consolidation, to a very large extent, determines the method of investigation employed in particular cases For example, the investigation for a consolidation whose primary object is to reduce operating expenses, will concern itself mainly with the overhead costs of the proposed members of the consolidation, and the production costs of their plants The investigation preliminary to a railroad consolidation to control and divert traffic will primarily concern itself with a study of the nature and volume of the freight business arising within the territory, and with traffic which seeks its destination in the same region

The starting point of every consolidation investigation is a compilation of the income accounts and balance sheets of the companies to be merged. Sometimes great difficulty is encountered in reducing these figures to comparable terms A familiar illustration is the contest over the amalgamation of the Youngstown Sheet and Tube Company and

the Bethlehem Steel Corporation, which ultimately failed of accomplishment Calculations of earnings by accountants engaged by each of the two companies, because of the divergent methods used—in particular the inclusion in Bethlehem profits of bonuses paid out of these profits to executives—exaggerated the earnings of the Bethlehem Steel and gave Youngstown, so its owners contended, too small a share of the securities in the proposed consolidated company.

In addition to comparative income accounts and balance sheets, there may be, although this is not invariably demanded, an appraisal of the tangible and intangible assets of the companies entering the consolidation Beyond this, the investigation, as already shown, is influenced by the primary object of the particular consolidation, by the condition of the security market, and by the amount of cash required among other matters peculiar to particular situations, for example, the demands of officer stockholders for salaried positions in the new consolidated company.

The Mechanics of the Investigation

Our next inquiry concerns the mechanics of the investigation of new business propositions The first distinction encountered is between the investigation conducted by a successful established business with its own research staff, and the investigation preliminary to the organization of a new enterprise to develop a business opportunity whose soundness the investigation is supposed to determine. Many large companies such as Du Pont, General Electric, General Foods, and Procter and Gamble make their own investigations with their own staffs, continually employed in work of this character

In the absence of such a research staff, and especially if the investment banker is to furnish the money, the work of investigation is turned over to some engineering firm of repute in the particular field The leading engineering firms in the United States which are engaged in investigation, as well as in construction, are United Engineers and Constructors, Inc.; Ford, Bacon and Davis, Sanderson and Porter, and Stone and Webster. These companies have large and specialized organizations. They are also able to summon to their aid, through their various connections, experts in every line of business activity The procedure is as follows

A promoting syndicate, or an established company, approaches an investment banker with the request that he buy an issue of securities His answer is that he knows nothing about the project, and has not time to familiarize himself with its details. He is willing to be guided by the written opinion of an engineering firm of repute in this field. He may go as far as to make a commitment on behalf of himself and associates to the effect that, based on a favorable report being furnished by the engineers, he, the banker, will provide a stated amount of money on stated terms. This agreement, known as a contingent commitment, may be in writing, or if the relations between the parties are close, may rest upon a verbal understanding over the telephone.

After receiving such a commitment, the promoting group or the corporation seeking the banker's support, engages the engineer to make the investigation for the banker. Although the banker assumes no responsibility for the cost of the study, it is none the less made for him and at his request, by the corporation or group seeking his assistance The basis of payment for this work was, in the case of one engineering company, three times the pay-roll First comes the pay-roll itself It usually includes the compensation of a number of high salaried men whose salaries often run into five figures. Second, there is an equal amount for overhead, and third, the same amount for profit In addition, all traveling and incidental expenses are added. The total may run to imposing figures, although these are confidential. The writers know of an investigation where 200 high-priced men were engaged for five months in appraising the property and examining the accounts of a large public utility company as a preliminary to a large loan The minimum cost of this investigation was not less than $500,000.

Frequently, these engineering concerns, when financial conditions are favorable, bring opportunities to the attention of investment bankers, and support their suggestions with the results of preliminary surveys which they make at their own expense. They do this in the hope of professional engagements, both to make investigations, and also, which naturally follows, to secure the contract for construction, their primary object in these negotiations. In such cases, the engineers act as promoters of the enterprise. Before the market crash in 1929, from which a drastic curtailment of financial commitments and responsibilities is to be dated, these promoting engineers often risked their own capital,

either by themselves, or as members of underwriting syndicates headed by bankers, in the development of enterprises which they had introduced to the bankers

The relations between the investment banker, the promoting syndicate, and the engineer are peculiar. The engineer is employed by the promoters or by the corporation seeking loans. He is paid by his employer but his responsibility is not solely to his employer His responsibility is to his own reputation It is impossible to secure from any one of a dozen engineering firms of repute, such concerns as would be recommended by investment bankers to do work of this character, any report which does not give a full disclosure of all material facts relating to the proposition. It is almost unheard of that the source of their compensation should modify or influence in any way the nature of their report If they should so far depart from the standards of professional ethics which govern their activities, as to color a report submitted to an investment banker, they would be blacklisted throughout the country So far as the investment banking fraternity could influence the matter, they would receive no more engagements for investigation or construction.

This statement does not imply that engineers, no matter of what standing, are infallible. The engineers who recommended a large investment in a combination coal-mining and briquetting concern in the South were directly responsible for the loss of the entire amount. They were guilty of a serious error of judgment, and their reputation suffered accordingly. But they were not guilty of deliberate misrepresentation

Of course, it is well known that the United States is infested by a numerous and disreputable breed of so-called experts who can be hired to testify on any side of any question, and to furnish any statement according to the suggestions of their employers. The revelations brought out in 1933 in the investigation of the New York Title and Mortgage Company, which sold certificates of interest in real estate mortgages, showed how far these pseudo-experts are prepared to go to earn their fees The evidence revealed that in many cases the appraisers who were supposed to be reputable professional men, would be told what appraisal should be placed upon a property as a basis for a loan, and these instructions were carried out. A large part of the loss in real estate mortgage bonds and certificates was due to these over-appraisals.

Assembling the New Business Enterprise

The third step in promotion is assembly. This takes place, as a rule, after investigation has been completed, although, when the proposition requires control before investigation, the order may be reversed Assembly is the securing of control of the property or rights upon which the proposition must be based. In addition, assembly involves an increase in the value of those properties and rights obtained by the promoter A large block of real estate, suitable for the erection of an office building, may be much more valuable than the sum of the individual appraisals before assembly Out of this increase in value, the promoter and his associates take their profit.

There are two methods by which assembly may be carried out first, outright purchase, by which the promoter buys and pays for the property needed, either with cash or promises to pay cash in the future This method is usually not available The promoter, as a rule, does not wish to tie up his funds in the purchase of property at this stage. The promoter must always keep in mind the possible failure of the enterprise He may not be able to secure everything necessary to its success His financial backers may meet with reverses Many promising enterprises in the promotion stage were abandoned after the panic of 1929.

The Option as an Instrument of Assembly

The alternative to outright purchase of property is the option method An option is a privilege, existing in one or more persons or a corporation, for which payment has been made, giving the right to buy certain real or personal property from some other person or corporation, within a certain time, at a fixed price. An option is therefore an unaccepted offer which runs for a definite time It states the terms and conditions under which the owner is willing to sell his property, if the prospective buyer elects to accept them within the time specified in the option If the holder of the option, known as the optionee, elects to accept the offer of the owner of the property, known as the optionor, he must give notice to the optionor, and make tender of the consideration mentioned in the option By taking such action, the offer of the optionor is accepted, and thereupon becomes a contract binding upon both parties. If an acceptance does not emerge within the time specified, the optionor is no longer bound by his offer, and the option is at an end A person or corporation granting

an option on property is bound to make a contract to sell at a future time, and to convey a good title. An option contract, like any other contract, is based upon a consideration This may be nominal in amount, one dollar is a binding consideration. It is usual, if a substantial payment is made, as consideration for the option, to apply this on the purchase price of the property if the offer is accepted.

Rights under the Option

The rights of the optionee in the optioned property are those expressly set forth in the option contract, and those which may be implied from its terms. It is usual to give the optionee the right to enter upon, to examine, and sometimes to take temporary charge of the property which it is proposed to purchase. Another right commonly given to the optionee, in case the option is one to purchase a going concern, is to have an audit made of the books of the company to determine its profits for a term of years It may also be provided that the optionee shall have the right to hold the owner responsible for protecting the property against impairment in value. For example, the optionor must keep up the insurance, discharge all taxes, interest, and mechanics' lien obligations, and maintain the property in the condition suitable to the uses to which the optionee intends to devote it in case the rights under the option are exercised.

Another valuable right connected with an option contract, from the viewpoint of the optionee, is the right to assign the option. This right is not implied, but must be set forth in the option contract. The existence of the right to assign places the optionee in an advantageous position to negotiate with the proposed corporation. The funds necessary to purchase the property under option are to be furnished by the company. If the option is not assignable, these funds are turned over to the optionee, who acquires title to the property with the understanding that it is to be transferred to the company for an agreed compensation. An arrangement such as this places the optionee in a position to put the company to a great deal of inconvenience, and delay the development of the opportunity so long that its potential value may be destroyed A corporation adopting this method assumes the risk of a refusal on the part of the optionee to transfer the title to property which has been taken in his name as principal. To be sure, if the corporation has been careful to provide itself with adequate legal protection, the transfer will even-

tually be obtained, but only after a battle through the courts, sometimes continuing for long periods of time, and during the conduct of which, the development of the opportunity may be held in abeyance When, however, the option is taken in the form which makes it assignable, the optionee can immediately assign his rights under the contract to the company which can then take them up directly, by completing the negotiations with the optionor

By the obtaining of options, the optionee-promoter can make sure of his profit. Bankers' ideas of the value to them of new projects are apt to be very conservative, if the promoter is not protected by option contracts without which the bankers can not go ahead. They may even obtain these options for themselves. At best all that the promoter can expect is a small "finding commission," or a trifling stock interest in the new company When the promoter has his options, and especially when they are so drawn as to make possible their assignment, he is in a position to fight for his own hand, and to get for himself from the banker the full value of his services.

With real property, the remedy of the optionee, in case the optionor refuses to carry out his agreement to sell on being notified by the optionee that he is prepared to purchase, and after the purchase price has been tendered, depends upon where the legal title to the property resides at the time. When the title to the property is retained by the optionor, the optionee's remedy is to obtain a writ of specific performance from a court of equity The court, on proper showing being made, will issue this mandatory injunction, requiring the optionor to transfer the property. When, however, the title to the property, by transfer from the optionor, has passed into the hands of an "innocent" third party, the only remedy of the optionee is a suit for damages against the optionor. The measure of the damages may be the difference between the price named in the option and the present market price of the property. The damage to the optionee resulting from such conveyance may be prevented by recording the option at the time it is created. The purchaser of the property is no longer "innocent." He is chargeable with knowledge that certain rights in the property have been created by the option contract, and he makes his purchase subject to a liability to have a writ of specific performance issued against him by the court, which will compel him to deliver a deed to the property on receipt of the price named in the option. The option contract con-

forms with the requirements of any contract as to form and consideration, capacity of parties, and legality of object.

When an option is obtained on personal property in the form of stocks or bonds, the method usually adopted for the protection of the optionee against a sale to other parties, is to deposit the securities in escrow, that is, in the possession of some individual or institution acting as trustee, with instructions to the depository to turn them over to the optionee upon receipt of the price. Patent options may be recorded on the books of the patent office at Washington, and all purchasers of patents are required to take notice of options or assignments so recorded

In promotions involving the acquisition of contiguous parcels of real estate, or the purchase of shares of stock from numerous stockholders of a given corporation, the promoter conducts his negotiations with secrecy, because a premature disclosure of prices leads to a rise in asking prices by those who have not yet signed option agreements.

In buying options, the optionee, if well advised, includes in his contract a provision for the extension of his option for some designated period. Frequently the final details of the promotion work can not be accomplished within the period of the original option, and the expiration of the option, without a certainty of renewal, might be fatal to the enterprise.

Financing the New Business

The proposition has now been assembled. The owners of the property have obligated themselves to sell to the promoter at a certain price during the period named in the options. It is known how much the property and the development of the venture will cost. The property is under the promoter's control The next step is to finance the enterprise The financing of an enterprise is the provision of the funds necessary to launch it as a going concern, with title to the necessary property, with a sufficient amount of cash in hand to carry its operations beyond the point where sales will replenish outlays, and also sufficient to meet outlays for taxes, insurance, and rentals. In addition, the financial requirements of any proposition properly set up must contain a margin for contingencies, because contingencies always arise. Mr. John D Rockefeller, in his *Random Reminiscences of Men and Events,* was particularly definite upon the necessity of providing for unforseen emergencies which, as he says, are always met with The comparative studies made

by Dun and Bradstreet show that the majority of failures among new business concerns during the early years of their existence, are due to insufficient working capital. It will bear reemphasis at this point that the investigation should show the amount of capital required, and that the amount indicated should provide for an ample excess to take care of unforseen emergencies

Methods of Obtaining the Needed Funds

Having determined how much money is needed, the next question is who will advance it? The sources of funds for new enterprises are various An anthracite producing company may be persuaded to protect its trade against strikes by building a plant for the manufacture of artificial fuel at tidewater. The coal company advanced the money to a construction and operating company organized to build and operate the plant, taking the operating company's notes as a matter of form and to enable the writing down of possible losses. Or, if the enterprise starts from the grass roots, as did the Ford Motor Company, a group of friends and associates of the inventor or promoter may be appealed to, to advance the necessary funds. Mr Ford put in certain patents and applications for patents, good-will, experience, and other intangibles in return for 25½ per cent of the stock. Twenty-five thousand dollars of cash was supplied by other subscribers The Dodge Brothers agreed, in return for a stock interest, to manufacture a certain number of motors for the new car, and so the enterprise was financed

The third method of financing is for the funds to be advanced by a group of bankers and investors as parties to an underwriting agreement, either by loan or direct purchase of securities. The money is provided for the new enterprise in the expectation that after the period of development has been completed, and the record of earnings has been established, the new securities will be sold in the market. This method is discussed in detail in a later chapter.

CHAPTER 3

THE EVOLUTION OF THE MECHANISM FOR ADMINISTERING BUSINESS

The Sole Proprietorship

Business is conducted by three principal agencies first, the sole proprietorship, second, the partnership, and third, the corporation. Two other forms of business association of secondary importance to those just given are the joint stock association and the voluntary trust. The sole proprietorship is the simplest form available Historically, it antedates all other forms. Even to-day, in the number of business establishments, it exceeds all other forms. It is much less important when judged from other viewpoints. If the total number of manufacturing establishments is used as a standard, in 1929, 51.7 per cent were organized outside the corporate form. If the number of wage-earners employed, or the value of goods or services produced are used as a basis of comparison, the result is reversed In the same year, corporations employed 89.9 per cent of the average number of wage-earners and produced 92 1 per cent of the value of products.

Sole proprietorships still persist in types of activity which are carried on by hand methods, such as custom tailoring, where the demand for the product is limited or localized, where the product or service is not standard, where it is perishable, and particularly in the field of retail trade Agriculture is carried on almost entirely by sole proprietors, although in recent years, the number of large agricultural corporations in cotton, grain, fruit and truck raising, has shown marked increase with the enlargement in the scale of operation and investment in plant and machinery.

Advantages of Sole Proprietorship

Although the sole proprietorship is apparently waging a losing fight against forms of business association, it still persists in great numbers. There must be substantial reasons to explain this fact. These reasons are as follows.

First Secrecy The sole proprietor can keep the affairs of his business within his own organization His employees may know what is going on, but his competitors do not. He makes few reports to government agencies, and he files his income-tax return.

Second The ease with which a business may be started as a sole proprietorship as compared with forms of business association.

Third The economy in starting a business as a sole proprietorship This form of business organization requires no partnership agreements, no charters, no by-laws, none of the elaborate documents which are necessary to the starting of a business association.

Fourth· A minimum of delay or interference in making business decisions. While the partners, or the corporation directors and officers are deliberating, the sole proprietor is acting.

Fifth Freedom in the choice of a business. The individual can start in any business. He may engage in several enterprises at the same time which, under the laws of some states, a corporation can not do He may abandon an unprofitable business, without any formality except paying his debts and walking away from it.

These are important advantages of the sole proprietorship There have been cases where very large businesses have been built up under this form The John Wanamaker stores in New York and Philadelphia were conducted for many years by a sole proprietorship. The large money-lending business of Russell Sage was carried on by Mr Sage individually without partners or associates Stephen Girard's activities, aside from the Girard Bank, were carried on by him as an individual.

The mechanism by which a sole proprietor can grow is the agency device The sole proprietor can appoint as many agents to carry on different parts of his business as he chooses He can delegate and divide their powers and duties. The power of attorney is a common device in the business world. There is no reason, in the nature of the organization, why a sole proprietor can not take a trip around the world, leaving the direction of his enterprise to his trusted representative Even when the last page is turned, and the sole proprietor joins his ancestors, he may make provision in his will for the conduct of his business by his executors

Disadvantages of Sole Proprietorship

What are the disadvantages of the sole proprietorship? The first is the limitation of human ability. Business success involves several kinds of skills. The successful business man, operating by himself and making all the decisions in his business, considering the time required to build up his fortune, must be a good salesman. He must be a good accountant, production man, buyer, and financier. These skills are seldom found in the same man. For example, Mr. Henry Ford, measured by the amount of wealth quickly accumulated, is the most successful man of this or any other generation. The combined resources controlled by Mr. Ford in 1926, twenty-three years after he started business, is reported to have exceeded one billion dollars. And yet Mr. Ford, who has conducted a one-man business, although in the corporate form, falls short of the ideal in one important particular. He is a marvel as a production man. He is a shrewd buyer. He has been remarkably successful in avoiding labor troubles. His public relations have been satisfactory. He is the soundest of financiers. Where he fails, is on the side of salesmanship. It is well known that this is a crying weakness of the Ford organization. Mr. Ford knows how to make a good car at a low price, but he has repeatedly shown his inability to accommodate his product to the public taste, and to present it in an effective manner to the buying public. Mr. Andrew Carnegie knew little about the manufacture of steel. He was strong in business organization and finance. He was a super-salesman. He early recognized his limitations, however, on the side of production. As a one-man business the Carnegie enterprises would not have succeeded. But Mr. Carnegie gathered around him a group of young men whom he fondly called his "young geniuses," who severally represented a high development of skill in every branch of steel production. It was this ability to select a group of highly skilled specialists, whose general direction remained in his hands, that distinguished Mr. Carnegie. If Mr. Ford possessed the highest sales and merchandising ability, it is not going too far to say that his share of the automobile market would be much larger.

These few illustrations show the necessity for associative effort in business. The course of human development has been marked by the birth of few men who are comparable to Mr. Henry Ford. The ordinary business man is of limited capacity. The successful business organization

is like a skilled orchestra conducted by a man with a genius for guiding other people The conductor may have skill on only one instrument, and yet he can keep fifty men playing in harmony

It is impossible for the sole proprietor, as long as he remains a sole proprietor, to admit his subordinates, no matter what their ability and performance may be, to a share in the ownership of the undertaking The employee may receive a large salary. With the partnership, if a young man shows distinguished ability, he is given an interest, and his fortunes are thereby bound up with the fortunes of the group As an individual agent, however, the only bond which unites him to the organization is his salary and bonus, and this is not ordinarily sufficient to prompt his utmost efforts In the Carnegie organization, for example, Mr Carnegie was careful from the beginning, as an employee showed ability, to give him a partnership interest. In one case, that of Mr William Jones, General Superintendent of the Edgar Thomson Works, this offer was refused, and a "thundering big salary" of $50,000 a year taken instead

The third objection to the sole proprietorship is the difficulty of financing a business out of its earnings The sole proprietor, if successful, wishes to expand his enterprise. As long as he remains by himself, he is limited to two sources of funds first, the earnings of the business, and second, such loans as he may be able to negotiate These resources may not be sufficient. The necessity of additional funds is a controlling reason in the conversion of many sole proprietorships into partnerships

The fourth important objection to the sole proprietorship is the unlimited liability of the owner. All of his assets, wherever located, are responsible for the debts arising out of every one of his undertakings

The Association of Individuals—The Partnership

In order to escape the difficulties and embarrassments inherent in the sole proprietorship form, various types of business associations have been developed in more or less chronological order These fall into three main sections first, the partnership, with its various ramifications, second, the corporation, and third, the voluntary association, or Massachusetts Trust We shall consider these in the order named

The partnership is a voluntary contract between two or more persons by which they combine their properties, skill, and labor in the transaction of business for their common profit Being a contract between

individuals, the partnership does not merge the identity of these individuals in the association The distinguishing characteristics of the partnership are as follows first, limited succession The partnership, being an association of two or more individuals, can not survive the elimination of one of the partners by death, bankruptcy, or voluntary withdrawal. Death of the partnership does not necessarily imply the death of the business. It may be sold to another partnership, and so carried on without interruption, but the original partnership, in the event of the occurrence of any of the events named, comes to an end, although it may be succeeded by another.

This limited life of the partnership often opens the way to embarassment. It is necessary to account to the executors of a deceased partner or to a retiring partner, for the value of his partnership interest, and while the method of ascertaining this valuation is generally provided for in the articles of co-partnership, yet disputes as to how the methods of valuation shall be applied, misunderstandings between partners, etc., such as characterized the famous Carnegie-Frick controversy of 1899 when, under an agreement, junior partners could be ousted and paid "book value" for their interest—book value being much less than true value—frequently arise to embarrass the business. In some cases, unless provision has been made to realize on the interest of a deceased or retiring partner by life insurance, or by provision for payment over an extended period, embarrassment to the business may result. The incorporation of J. P Morgan and Company is reported to have been influenced by heavy withdrawals of assets in recent years to pay off deceased or retiring partners. In this respect, the partnership is inferior to the sole proprietorship As already shown, an individual can provide for the perpetuation of his business by direction in his will, and no one, as long as the business remains solvent, can interfere with the carrying out of these directions In the partnership, however, the death or withdrawal of a partner may lead to the destruction of the business by the sacrifices involved in a forced liquidation.

The second characteristic of the partnership is unlimited liability In changing from the sole proprietorship to the partnership, the business man has not eliminated this defect. He has made only a partial escape from the unlimited liability for all his debts and obligations, which falls upon the sole proprietor. In the partnership, each partner is jointly liable to the full extent of his resources for all the debts of the partner-

ship as a business, and he may be held to answer to partnership creditors to the full value of his private estate outside of the partnership assets. However, the individual partners can not impose liability upon their fellow partners for their private undertakings outside the partnership activities, except as to the value of their partnership interest. Under the condition last described, the creditor of a partner sometimes has it in his power to force a dissolution in the same manner as the executor of the estate of a deceased partner can force a liquidation of all the assets of the business. Either contingency is, however, remote What the executor and the creditor are each seeking is the largest available amount of value for the interests in their keeping, and this desire can be best realized by negotiation with the surviving and solvent partners.

The third characteristic of the partnership is specialization of business functions To one partner may be entrusted the buying, to another the production management, to a third financing, to a fourth the sales, and to a fifth partner the role of Andrew Carnegie, who "drove the bandwagon and cracked the whip." The partnership business may be expanded. When Carnegie Brothers and Company, Ltd, was finally turned into the Carnegie Steel Company, Ltd, there were thirty-five partners in an organization which had started with seven One of the principal advantages of the partnership, as compared with the individual proprietorship, is that it enables the inclusion in the organization of promising managerial or promotive talent, as well as the addition of needed funds contributed by new partners The usual method of taking in new partners from the executive staff, is to fix a value upon the interest assigned, charge the incoming partner with the value so determined, plus interest at an agreed rate, charge him also with a drawing account to compensate him for his services, and credit him from time to time with any improvement in the value of his interest.

As the incoming partner is credited with his share of accruing profits against his debits, so he is charged with his share of losses A situation has often arisen where, in place of reaping a large fortune, a partner has been saddled with a large debt which he may spend many years in paying off In one case of this kind, an executive of a large brokerage firm purchased a 10 per cent interest for a substantial sum of cash, plus the assumption of a large debit balance This was during the boom years preceding 1929. At the peak of the market, his interest, for which he paid only $65,000 in cash, was worth $500,000. After the smash, as

a result of some unwise investments of the firm, he owed them $300,000 If the business is successful, however, the new partnership interest may become very valuable As a matter of historical record, it should be held in affectionate remembrance by aspiring young business men that the valuation of the partnership interest of Andrew Carnegie's partners, expressed in terms of stock and bond par values received, was $149,-502,000 when their organization became the Carnegie Company, although they had contributed little beyond their several services.

In concluding the discussion of the characteristics of the partnership, as distinguished from those of the sole proprietorship, we must call attention to certain modifications of the partnership form, which work for its improvement. We refer to the special partnership and the limited partnership, by which partners who do not wish to take an active part in the management of the firm, upon proper public notice and compliance with the formalities of registration, may limit their responsibility to creditors of the firm, to the amount of funds or property which they have contributed, plus the accretions to this fund which come to them under their agreement

We have shown that the partnership, in some respects, is a form of business organization superior to the individual proprietorship It is, however, open to serious objections The liability of general partners to outsiders is unlimited The accumulation of capital for expansion of the partnership is customarily limited to reserves from profits, contributions by special or limited partners, or to contributions by new general partners. In exceptional cases, as with the Carnegie Steel Company, Ltd , these resources may be adequate, but in necessary expansion, common opinion, from the standpoint of accumulation of capital, favors some more flexible form of business organization The partnership of whatever type, in the absence of agreement, is also subject to the disadvantage that a partnership interest is not freely transferable If a partner desires to dispose of his interest to an outsider, he may do so only if the remaining partners are willing to accept the newcomer.

The Corporation

The corporation is an ancient institution Its ancestry may be traced back to Roman times Many similarities to the corporate form as we know it to-day have been found in Roman institutions. The corporation is a creation and a creature of the state Until about the middle of the nine-

teenth century in the United States, corporation charters were granted by special acts of state legislatures The large increase in the use of the corporation as a form of organization, the desirability of retaining control of these artificial persons by the state under the police power in the interest of public welfare led to the passage of general incorporation acts Under these acts a number of individuals as prescribed in the law, usually three or five, by complying with the stated formalities of incorporation can form themselves into a corporation, as Blackstone describes it—a little republic.

With the facilities afforded by the general incorporation laws, this form of business association has been generally used From this point, we have to do with the corporate form of associative enterprise

A corporation is an association of individuals authorized by the state, under an instrument called the charter or certificate of incorporation, to transact a particular kind of business, together with all kinds of business collateral or incidental to the main line of activity, and, in the transaction of this business, to buy, sell, lease, mortgage, employ, borrow, and lend, and in all respects, for the transaction of its particular business, act as a natural person It is an association with a life, a personality, a will, and a reputation of its own, altogether apart from those of its individual members

Limited Liability of the Corporation

First, as to the liability of the owners of a corporation—the corporation stands between its own creditors and the outside resources of its owners These creditors, having dealt with and trusted the corporation, must look to the corporation for payment. Since the creditors, in the incurring of the debt, do not recognize the members of the corporation as individuals, they can not leap over the corporation in the process of collecting their debts and seize the real and personal property of the members of the corporation which they hold as individuals, apart from their interest in the corporation All of the property owned by the corporation, its creditors can seize and sell. Its members may lose every dollar they have put into the business Other property which they possess they can not lose because of the misfortunes of their company [1]

[1] It is not unusual, however, for members of a corporation to assume personal liability as guarantors or sureties for the debts of the company When the company is small, or when, although large, its credit is not good, such help from stockholders is often extended The guarantor, endorser, or surety, if prudent, gets such security as the company can give him

This is the "limited liability" of the corporation which so strongly recommends the corporate form of organization to the investor who looks for income with the minimum of risk. In a partnership, the investor must be always on guard lest some careless or fraudulent act of a fellow partner involve the business in ruin, the effects of which might spread to his private resources In the corporation, on the other hand, while the consequences of failure to members are serious enough, yet these consequences do not overflow the boundaries of the company's assets. In some cases, as, for example, in the double liability provisions of some state corporation laws, liability additional to the members' interest in the company is imposed upon them, but even here the amount of liability is fixed and known to the members.

Perpetual Succession of the Corporation

The second advantage of the corporation over the partnership is the respective life durations of the two organizations The partnership, being a group of men, Jones, Brown, and Robinson, doing business as a group, can endure only so long as all of its members are alive, and so long only as each one remains solvent and willing to continue in business relations with the partners. The death of Jones, the bankruptcy of Brown, or the withdrawal of Robinson, each will operate to dissolve the partnership and conceivably to dissolve the business It is true that enterprises have been conducted under the partnership form for many years, lasting, in the case of the Baldwin Locomotive Works, for example, through four generations of partners, but this was due to the conjunction of several favorable factors, not always met with prosperous business, harmonious relations between the partners, which resulted in provisions being made for the valuation and transfer of the interests of deceased partners, and the admission of valued employees from time to time into the partnership. The Baldwin Locomotive Works, in spite of the disadvantages of the partnership form, continued as such until 1911, when it was incorporated

The partnership relation is subject to the vicissitudes of human life The personnel of the firm may be changed by the death of a member, or, if one member is the chief source of firm capital and he becomes bankrupt, his creditors may bring about a liquidation of the business. Finally, if one member is embarrassing the firm by his tortuous conduct or by his personal incapacity, such as permanent illness or insanity,

the personnel of the firm may be changed by the other partners obtaining a court decree for his removal. Whether the business is actually terminated or not by any of the foregoing contingencies, depends upon the circumstances of the particular case.

No such difficulty need be feared with the corporation. The life of the corporation, a life separate from the lives of its members, can be projected, by the terms of its charter, forever. No matter what may happen to the members, the life of the corporation goes on. Every original member may die, every original member may become individually insolvent, every original member may withdraw from the association, and yet the life of the company will continue, carried on by their successors.

Sir William Blackstone, in his *Commentaries* has described the immortality of the corporation in a passage of singular force and beauty.

> In order to facilitate business and to increase production of wealth, there have been created by acts of the public power, running back to remote antiquity, associations for business, religious, governmental, and charitable purposes known as corporations. These artificial persons are called bodies politic, bodies corporate, or corporations, of which there is a great variety subsisting, for the advancement of rights and immunities, which, if they were granted only to those individuals of which the body corporate is composed, would upon their death be utterly lost and extinct. To show the advantages of these incorporations, let us consider the case of a college in either of our universities, founded for the encouragement and support of religious learning. If this were a mere voluntary assembly, the individuals which compose it might indeed read, pray, study, and perform scholastic exercises together, so long as they could agree to do so: but they could neither frame, nor receive any laws or rules of their conduct, none, at least, which would have any binding force for want of a coercive power to create a sufficient obligation. Neither could they be capable of retaining any privileges or immunities: for, if such privileges be attacked, which of all this unconnected assembly has the right, or ability, to defend them? And, when they are dispersed by death or otherwise, how shall they transfer these advantages to another set of students, equally unconnected as themselves? So also, with regard to holding estates or other property, if land be granted for the purposes of religious learning to twenty individuals, not incorporated, there is no legal way of continuing the property to any other persons for the same purposes, but by endless conveyances from one to the other, as often as the hands are changed. But when they are consolidated and united into a corporation, they and their successors are then con-

sidered as one person in law as one person, they have one will, which is collected from the sense of the majority of the individuals this one will may establish rules and orders for the regulation of the whole, which are a sort of municipal laws of this little republic, or rules and statutes may be prescribed to it at its creation, which are then in the place of natural laws the privileges and immunities, the estate and possessions, of the corporation, when once vested in them, will forever be vested, without any new conveyance to new successions, for all the individual members that have existed from the foundation to the present time, or that shall hereafter exist, are but one person in law, a person that never dies in like manner as the river Thames is still the same river, though the parts which compose it are changing every instant.

The perpetual existence of the corporation gives it great advantages over the partnership. The corporation can enter into contracts, such as franchises or mortgages, extending over many years. It can undertake programs of construction which may require a quarter of a century for their completion In can offer to the investor a permanent resting place for his income-seeking funds.

Transferability of Interest in the Corporation

Connected with the advantage of perpetual succession which the corporation enjoys over the partnership is the advantage of transferability of interest Any partner can force his way out of the association without the consent of his fellow partners, usually at the expiration of any year, or, at best, at the end of a short term of years, but no outsider can force his way in to replace the one who withdraws, without the consent of each one of the remaining partners. The partnership relation is so intimate, so personal, the partners are joined so closely together in their duties and responsibilities, that unanimous consent is rightly considered to be necessary before new members are admitted This fact makes partnership interests unavailable for general investment purposes. Even if the investor could get his money into the partnership, which, unfortunately, is not as difficult, in some cases, as it should be, he may find it difficult to get it out again on short notice, unless, of course, he advances money in return for promissory notes, in which capacity, he is a creditor and not a partner With the rapid growth in the scale on which business is conducted, and the consequent necessity of drawing money from more people for its capital equipment, this difficulty

of transferring interests counts strongly against the partnership form of organization.

The stock of a corporation, on the other hand, is divided into shares. These shares are the personal property of those who hold them, normally free from any limitation or restriction on the right of transfer. Any stockholder may sell his stock to any one, and all of his fellow stockholders acting together are powerless to prevent the admission into the association of the new member thus created. The way is thus opened for the free circulation of investors' money from one corporation to another by buying and selling of stock.[2]

Representative Government of the Corporation

The final advantage possessed by the corporation over the partnership is representative government. In a general partnership, each member of the firm is an agent of the firm, and can bind the firm. The partners are presumed by law to trust each other in the conduct of the business. The acts of each partner have equal force with the acts of any other. This fact makes membership in a partnership, for any investor who is not in a position to give his personal attention to the business, extremely hazardous. His fortune may be swept away by an ill-advised or fraudulent course of action taken by his partners without his knowledge. Personal attention to the affairs of a partnership by each of the partners is therefore essential, and, though this makes for the highest business efficiency where the partnership is harmonious and well organized, since the "eye of the master" is on every part of the business, it limits the number of members, and therefore the amount of money which can be placed at the firm's disposal.

In the corporation, on the other hand, we have a system of representative government. A group of individuals come together under the powers given them by the corporation law of the state, and draw up a certificate of incorporation. This instrument gives the name of the corporation, its objects, the amount of capital it is authorized to raise, the location of its principal office, the period of its duration, the names and post-office addresses of the original subscribers and the amount of

[2] In some states, for example, Michigan, it is permissible to restrict the right of selling stock by a stockholder, by the requirement printed on the back of the certificate that stock must first be offered to other stockholders, at the price offered by others before such an offer can be accepted.

their several subscriptions, and provisions for the regulation and conduct of the affairs of the corporation This instrument is recorded also and filed with some state officer—in New Jersey, the Secretary of State—and the subscribers thereupon become a corporation

The corporation now organizes by setting up its government to regulate its affairs The principle of representation is applied. The shareholders select from their number [3] certain directors or trustees to manage the business This the law requires. There may be in time many thousand shareholders scattered all over the world, but few of these shareholders know anything about the business owned by the corporation of which they are the owners, save as they may in time receive dividend checks, or when their voting proxies are solicited. It is impossible, even if it were desirable, that the shareholders should come together at frequent intervals to give their attention to the management of their business. So they delegate directors to represent them. The shareholders, both in the certificate of incorporation or charter, and in the by-laws or regulations supplementary to the charter, can lay down the fundamental laws by which they wish the business of the company to be governed, just as the sovereign people in their constitutional convention, change and add to the fundamental laws of the state by which the constitutionality of every statute passed by the legislature, must be tested. But having passed these laws, both citizens and shareholders, except on matters which they have reserved for their own decisions—such, for example, as the borrowing of money by the state, or the mortgaging of property to creditors, or the creation of new stock having priority as to dividends over existing issues, by the private corporation—must leave the decision of questions of public or corporate policy to their elected representatives.[4]

[3] Some states, Delaware and Pennsylvania for example, do not require directors to be shareholders unless the articles or by-laws so provide

[4] A stockholders' meeting of the Pennsylvania Railroad Company is recalled, which was enlivened by a polite and even amiable protest, voiced by Moorfield Storey, representing certain New England stockholders, against the method of selling securities to fiscal agents, at that time Kuhn, Loeb and Company, which the company had followed Mr Storey suggested that the stockholders should be given an opportunity to share in the profits of these bankers The directors, speaking through the financial Vice-President, the late John P Green, vigorously replied that the stockholders had elected them to manage the affairs of the company, that, in their judgment, the method of selling securities to bankers was the best, and that if the stockholders were dissatisfied, they could select new directors Needless to say, the meeting, largely attended by holders of proxies, upheld the directors

Administration of the Corporation

Even the directors are not supposed, as directors, to manage the routine of the business. For example, the General Corporation Act of New Jersey in Section 12, provides that "the business of every corporation shall be managed by its directors who shall respectively be shareholders therein, they shall not be less than three in number; and except as hereafter provided, they shall be chosen annually by the stockholders, at the time and place provided in the by-laws, and shall hold office for one year and until others are chosen and qualified in their stead."

However, it is further provided that "every corporation organized under this act shall have a president, secretary and treasurer, who shall be chosen either by the directors or stockholders, as the by-laws direct, and shall hold their offices until others are qualified in their stead"

These officers and others who may be provided for in the charter or by-laws, manage the business of the company under the general supervision of the directors, who, even though they may hold weekly meetings, can do little more in reference to the routine management of the business, than to pass upon the reports of the managers.

In this universal application of the principle of representative government to corporation management, lies another safeguard for the investor He can not manage the business himself. He must turn it over to others to manage These elected representatives stand in a fiduciary relationship to the corporation and all of its shareholders They are agents of the corporation The rules under which this relationship is to administer are set down in the law of the state and in the charter and by-laws of the company. For any violation of these rules, the directors are liable to the corporation and its shareholders. The law requires directors to give—and the vast number of prosperous corporations now in existence proves that the directors do give—to the corporation, the benefits of honest, careful, and diligent supervision of its affairs. In the same way, directors generally receive faithful and intelligent service from the administrative officers of the company, to whom they must delegate not only the routine of management, but the initiation and carrying out of important policies of construction, consolidation, and expansion

As the directors represent the shareholders and administer the affairs of the company in accordance with the constitution of the corporation,

so the officers, as the executives, represent the directors Both officers and directors have their spheres of activity defined in the charter and by-laws, supplementing the corporation law of the state, just as the public law lays down in detail the rules by which public officials must conduct the affairs of the state. And furthermore, just as the public legislators must go back at frequent intervals to the electors to give an account of their stewardship, so the corporation directors must obtain from their constituents, the shareholders, at intervals, approval of what they have done and the right to continue in their positions.

Even in companies like the United States Steel Corporation and the American Telephone and Telegraph Company, with armies of shareholders and assets running into the billions, the representative form of government, extending through the directors and officers of the parent company down through the directorates and administrative boards of the principal subsidiary companies, and of the subsidiaries of these subsidiaries, can expand with the growth of the business. The corporation can indefinitely increase the number of its shareholders and the amount of its capital, without impairing the efficiency of its organization.

We have already seen how flexible is the organization of the business corporation We now understand how complete are the powers of this association to transact business as a natural person We have also seen how superior is the corporate form of organization to that offered by the partnership. The business corporation is the accepted form of business organization When men come together for the prosecution of any joint enterprise, it is unusual for them to organize under the partnership form Even in those states where laws provide for limited partnerships, wherein the liability of the partner may be confined to the specific amount he invests in the business, or where, as a silent partner, he takes no active part in the management of the business, the corporate form of organization prevails.

The Massachusetts Trust as a Substitute for the Corporation

Efforts have been made to improve upon the corporation as a form of business organization. The Massachusetts trust is the favorite substitute. By this plan, certain property is transferred to trustees to hold for beneficiaries and to manage the property as active agents. These trustees issue voting certificates of interest in the property and profits of the trust, to the beneficiaries, and on these certificates dividends are

paid. The beneficiaries select the original trustees who hold office in accordance with the terms of the deed of trust It is still an open question in some jurisdictions whether trustees under such instruments can escape the liabilities of partners. This plan is advocated primarily as a means of avoiding certain corporate taxes, such as the capital stock tax, and regulatory statutes which are numerous and burdensome upon corporations. It has no other substantial merit.

CHAPTER 4

THE CORPORATION

The corporation is a creation of the state. There are forty-eight separate state sovereignties in the United States, and the District of Columbia, and each one of them will issue a charter to a group of incorporators to carry on a business for any lawful purpose or purposes, either within their boundaries, or anywhere within the United States or foreign countries The federal Congress has not passed a federal incorporation act This has been repeatedly proposed as a means to bring under federal control all corporations engaged in interstate commerce, but as yet nothing has come of this agitation A bill is now pending providing for Federal licenses for state corporations engaged in interstate commerce. The object of this bill is to establish federal control in the absence of federal incorporation.

Federal Governmental Corporations

Present day governmental corporations may be divided into two groups (a) federal business corporations, and (b) federal governmental corporations. Included in the first group of corporations are those which are federally chartered, in which private rights are represented by stock ownership and board representation, such as national banks and national farm-loan associations. The second group includes corporations which, while federally owned and controlled, are incorporated under charters granted by particular states, such as Reconstruction Finance Corporation Mortgage Company, organized under the laws of Maryland, Commodity Credit Corporation, Federal Surplus Commodities Corporation, Federal Subsistence Homestead Corporations, Public Works Emergency Housing Corporation, incorporated under the laws of Delaware, Tennessee Valley Associated Company Operatives, Inc , incorporated under the laws of Tennessee, and Electric Home and Farm Authority and Export-Import Bank of Washington, incorporated under the laws of the District of Columbia. When the federal govern-

ment wishes to engage in a business it does so through the instrumentality of a state-chartered corporation.

The Constitution of the United States reserves to Congress the control of commerce between the states and with foreign nations. By a variety of laws and by many instrumentalities, such as the Interstate Commerce Commission, the Federal Trade Commission, the Federal Power Commission, the Federal Communications Commission, the Securities and Exchange Commission, among others, the federal government makes this control effective. The corporations which carry on this interstate business, however, under federal control, are themselves state corporations and subject to the laws of every state in which they do business, in such matters as wages, hours and conditions of labor, taxation, building restrictions, safety and health laws, and a variety of other regulations which are imposed upon all business, personal and corporate. The state of Maryland, for example, requires that all foreign companies engaged in interstate commerce in Maryland maintain at least one resident agent in that state whose name and address, as such, have been certified to the State Tax Commission, and also a mailing address which has been certified to the same Commission as long as the company is subject to suit in the State of Maryland. The federal government cares for none of these things. It is, as yet, only interested in matters affecting interstate commerce directly. It supervises very closely through the Interstate Commerce Commission, the activities of the railroads, and interstate bus and truck lines, even extending this control to the type of railway equipment and to the compulsory installation of safety devices in the form of air-brakes and automatic signals. It also, through the Federal Trade Commission, attempts to enforce the rules of fair trade upon companies engaged in interstate commerce. It is especially concerned to prevent the formation of any illegal combinations in restraint of trade. The federal government also supervises the interstate shipment of live stock, in order to prevent the spread of dangerous contagious diseases. It has recently largely increased its control over the enforcement of the criminal law. For example, the transportation of a stolen automobile across a state line, or the transportation of a kidnapped person across a state line, or the crossing of a state line in order to escape a court subpoena, or any crime affecting an agency of the United States, for example, a bank, a member of the Federal Reserve System, are now federal crimes.

Beyond these excursions into the realm of regulation, however, the federal government leaves the control of business activities to the supervision of the several states [1] Out of the forty-eight state jurisdictions, the incorporators might naturally be supposed to select the state in which their principal place of business is to be located. We find immediately certain limitations to this general rule The first is the type of business. We have two kinds of business recognized by the laws of the state: first, that which has to do with public interest and public service, and second, non-public service business. Both kinds of business are conducted mainly by corporations The public corporations, however, are more closely and carefully regulated by the public authorities because their activities affect the lives of all the people in their immediate areas

Public vs. Private Corporations

Examples of public service corporations are railroads, street railroads, water, light and power companies and telephone companies On the other hand, there is the class of non-public service corporations which includes all corporations organized for profit, and religious and charitable organizations, not affected with a sufficient public interest to subject them to detailed regulation. These companies are engaged in mining, manufacturing, trading and various types of service, such, for example, as hotels, restaurants, and amusements. The first class of companies, those affected with a public interest, must be organized under the laws of the state in which their business is to be done; and if their business extends into other states, separate corporations under the same ownership must be set up to comply with the provisions of the corporation laws of those states.

The Organization of a Public Corporation

For example, the Pennsylvania Railroad Company is a Pennsylvania corporation This company carries on its business, however, in New Jersey, New York, Delaware, Maryland, Virginia, West Virginia, the District of Columbia, Ohio, Indiana, Illinois, Kentucky, Michigan and

[1] In a recent case, the Apex Hosiery case, the Supreme Court refused to take jurisdiction in a damage suit against a union, on the ground that the sit-down strike, out of which the alleged damage occurred, did not materially interfere with interstate commerce, and that to hold otherwise would place most strikes under the federal law

Missouri. In each state outside of Pennsylvania, operations of this railroad are carried on by corporations organized under the laws of those states, and these corporations are controlled by the Pennsylvania Railroad Company.

The New Jersey lines of the Pennsylvania Railroad are owned by the Pennsylvania-Reading Seashore Lines and by the United New Jersey Railroad and Canal Company, both chartered under the laws of New Jersey The lines west of Pittsburgh are owned by the Pittsburgh, Cincinnati, Chicago and St. Louis Railroad Company, incorporated in Illinois, Indiana, West Virginia, and Ohio, the Pittsburgh, Fort Wayne and Chicago Railway Company, incorporated in Indiana and Illinois, the Pennsylvania, Ohio and Detroit Railroad Company, incorporated under the laws of Michigan, and many other companies Among the lines of the Pennsylvania Railroad serving the states south of Pennsylvania are the Philadelphia, Baltimore and Washington Railroad, the New York, Philadelphia and Norfolk Railroad, and the Delaware, Maryland and Virginia Railroad, incorporated respectively under the laws of Delaware, Pennsylvania, and Maryland, Maryland and Virginia, and Delaware, Maryland, and Virginia Each one of the companies, or the properties which it owns, is controlled by the Pennsylvania Railroad Company, and all of their properties are operated as a unit throughout the Pennsylvania Railroad Company territory. The individual corporations, however, are subject to the regulatory supervision and control of the public authorities of the particular state which incorporated them.

The Organization of Private Corporations

The private corporation, not affected with a public interest, is allowed, under our system of interstate comity, to organize in any one of the forty-eight states and, after establishing its location in the state of its choice, to sally out over the entire country, and do business in every other state in the Union For example, the corporation law of California, in listing the powers of corporations, gives to any corporation chartered by it, the power to "qualify to do business in any other state, territory, dependency, or foreign country, and to conduct business within or without the state." In fact, it is not necessary that it should do any business, as business is properly understood, in the state of its incorporation The meaning of doing business is described in a pamphlet issued by the

Corporation Trust Company, entitled "What Constitutes Doing Business by a Corporation in States Foreign to the State of its Creation."

The question whether corporations are lawfully subject to statutes in the various states requiring the taking out of licenses or permits or are exempt from such restrictions turns on whether the character of the business in the state constitutes interstate business or constitutes the doing of business in such a manner as to localize the business and to make it an operation within the state Transactions in the latter class are commonly referred to as "doing business"

Doing business, for example, means buying real estate, erecting buildings, equipping them with suitable machinery, employing labor, purchasing materials, fabricating these materials into finished products, selling the products, and collecting the money Such operations by a corporation organized under the law of Delaware, can be carried on in Oregon, 3,000 miles away from the home of the corporation, with the same freedom and facility enjoyed by an Oregon corporation. It might be supposed that this 3,000 miles of separation between the home of the company and its plant, would interfere with the close supervision of its activities which is necessary to success. This, however, is not the case While the home of the corporation may be in Wilmington, Delaware, where it is represented by an agent, the entire business organization of the company, and all the members of the directing force, including the directors and officers, can be residents of Oregon, where the plant is located. No one of the directors need be a resident of the state of Delaware.

Illustration of a Foreign Corporation

The General Motors Corporation furnishes an illustration of this rule It is a Delaware company It "does business" in fourteen states In each of these states it owns or leases real estate and carries on manufacturing and selling operations Most of its business is centered in southern Michigan

To the extent that these corporations are engaged in business activities in states other than those from which they have obtained their charters, they do so as *foreign* corporations All foreign corporations are, however, subject to all of the laws and regulations of each state in which they do business. For example, the states differ in their real estate laws, in their tax systems, in their labor regulations, in their sanitary,

health, and safety regulations, and in their systems of wage payment. Some states stipulate minimum wages. Many states have varying drastic regulations affecting the labor of women and children Domestic corporations are subject to these regulations, and it is, of course, unreasonable to expect that any state would allow foreign corporations greater liberty within its borders.

Factors Influencing the Doing of Business as a Foreign Corporation

What, then, is the value to a corporation of establishing its birthplace in Delaware and its business in another state? As a corporation, it is engaged in making profits To make profits it carries on a business. Its stockholders naturally wish to carry on this business with the greatest freedom of action, the least inconvenience and restraint In other words, while selecting the corporate form of business organization, with its advantages of limited liability, transferability of interest, etc —which advantages differentiate it from the partnership or sole proprietorship—they wish to retain, as far as possible, the liberty of action possessed by these simpler forms of business organization.

An important difference between the state corporation laws relates to the purposes of the corporation. This was, in fact, the primary reason for the incorporation of companies in New Jersey on a large scale in 1889 In some states, as in Pennsylvania for many years, a corporation could be organized for only one purpose, for example, coal-mining. It could not carry on any other business except those activities, such as the operation of a company store, which directly contributed to that activity. If it was desired to operate a coal-mine, a gas-making plant, and a steel mill under the same corporate ownership, it could not be done. By incorporating in New Jersey or in Delaware, states which allow companies to be organized for many purposes, these objects could be accomplished

The item of expense is always present in the minds of incorporators. Various fees and levies are imposed by the state. Taxes are levied upon corporations, either upon their franchises, upon the value of their stock, or upon their loans Other things being equal, the incorporators seek the state where these levies and charges are smallest.

Another set of regulations relates to the obligations of the stockholders to the corporation, such as their liability for unpaid stock subscriptions, the valuations which they may place upon property purchased

with stock, the characteristics of the stock which they may issue, and the liabilities of stockholders for the debts of the company beyond the value of their stock interest. States also prescribe various rules to govern the management of the corporation—the number, qualifications, and liabilities of directors, the holding of meetings within or without the state, the location of the books and records of the corporation, and the amount of capital required to start the business An important advantage possessed by some states as a home for corporations is the complete interpretation of their corporation laws by state and federal courts New Jersey, Delaware, and New York are especially distinguished by such judicial interpretations.

Method of Organizing a Corporation

The organization of a corporation, once the state has been selected, is a simple and inexpensive operation The steps taken are as follows in Delaware The foundation of the corporation is the certificate of incorporation, known as the charter This certificate sets forth the name of the company, which must not be so similar to the name of an existing company as to arouse confusion in the minds of those who deal with the new company, second, the name of the county and city in which its principal office is to be located, its street address and the name of its resident agent, third, the nature of the business which it proposes to carry on, fourth, the description of the stock, fifth, the names and residences of each of the incorporators, sixth, the duration of the corporation, and seventh, any provisions which the incorporators may wish to insert for the management of the business and for the conduct of the affairs of the corporation For example, the law of Delaware provides in this respect that the charter may contain "Any provisions creating, defining, limiting, and regulating the powers of the corporation, the directors, and the stockholders or any class of the stockholders, or, in the case of a corporation which is to have no capital stock, of the members of such corporation, provided such provisions are not contrary to the laws of this state "

This certificate is prepared by the attorney for the incorporators, usually with the advice, if a company is selected, of the Corporation Trust Company, whose wide experience in these matters, drawn from the incorporation of thousands of companies, is placed at the service of the attorney In the meantime, a notice of intention to apply for the

charter will be published in one or more newspapers designated for the purpose in the county in which the home office of the corporation will be located, which notice or notices will indicate the date upon which application will be made for the charter The application papers are then forwarded to the designated state authority, usually the Secretary of the Commonwealth, and after due examination, and the payment of the necessary fees and taxes a copy of the Articles of Incorporation is transcribed, signed by the proper state officers, the state seal is affixed, and, upon its return to the incorporators, it becomes the charter of the company

The charter having been obtained, and a group of stockholders now existing, since the incorporators will have subscribed to the required portion of the authorized capital stock, the corporation is ready to organize for the conduct of business The first meeting of the stockholders will be called, and upon preliminary organization, will proceed to adopt a set of by-laws which the attorney will have prepared in advance These by-laws will contain the rules and regulations for the conduct of the corporate affairs, and they may not be contrary to the charter or the corporate law of the state

The Adoption and Nature of By-Laws

Examples of by-laws are stipulations relating to the duties of officers. For example, a by-law may provide that the president shall have the general management of the affairs of the company, or that two officers' signatures are necessary to any check drawn on the company's funds or to any acknowledgment of indebtedness into which the company may enter By-laws may relate to the powers of the directors They may provide for an executive committee to function during the intervals between directors' meetings, and may define the actions which this executive committee may take By-laws may relate to the rights of shareholders They may define the method of transferring stock; or they may provide for five days' notice of a special meeting of stockholders, or they may go into minute detail concerning the management of the business. For example, a coal-exchange corporation imposed a penalty of $2 00 a day in its by-laws on the use of cars by its members after a certain period There is no feature of company management which may not be lawfully covered in a by-law, provided it does not deprive stockholders of any vested right By-laws adopted at the time of

the organization of the company should be general in nature and should not too greatly limit the discretion of officers and directors to carry on the business of the company.

A by-law adopted at the time of the organization of the company is a fundamental contract between the stockholders and the corporation, the stockholders and the directors, and the stockholders themselves, and can not be changed without a vote of the stockholders, even though the charter may provide that by-laws adopted after the organization of the company, may be changed or supplemented by the directors without reference to the stockholders.

The next important matter of business is the election of a board of directors. Having accomplished this, the officers of the company will either be chosen by the directors, or elected by the stockholders, depending upon the provisions of the by-laws. The corporation is now a living organism, prepared to carry on the activities for which it was created.

The Promoter and the Corporation

At an early stockholders' meeting, the promoter secures the validation of any contracts into which he may have entered in the process of assembling the enterprise. He has no authority, as a promoter, to make contracts on behalf of a corporation not yet in existence. Such contracts entered into by the promoter are his individual obligations, and are not binding upon the corporation until they have been validated by the directors and also, preferably, by the stockholders on the directors' recommendation in the manner provided by law. It is in the validation of these contracts that the promoter "hives" his profit. If he has acquired options on property which he proposes to sell to the company for shares of stock, it is at this point that he must make the offer of sale and receive the corporation's acceptance. If he feels entitled to money compensation for his services, he must render his bill and obtain its approval. The corporation can refuse, if its directors and stockholders choose, to accept any contract entered into by the promoter, or to pay the promoter, and the company can go ahead without recognition of the time and money spent by the promoter on its behalf and for its benefit.

The promoter's position in this matter is delicate and dangerous. The courts have often held that hand-picked groups of incorporators, and directors, taken, it may be, from the clerical force of the promoter's office, subservient to him because they depend upon him for

their living, are not proper persons to validate contracts entered into between the promoter and the corporation which the promoters' efforts have brought into existence. The directors must be real directors, not "dummies." They must be capable of considering the fairness of the promoter's contracts, and the reasonableness of the compensation in stock or money which he claims as his due. At this point, it must be admitted that the ordinary practice leaves much to be desired from the promoter's standpoint Any stockholder, acting within a reasonable time, may question these contracts, and the court will set them aside and compel the refund of any money or stock paid, if it is shown that the directors who approved the contracts and authorized the compensation, were mere creatures of the promoter, so that, in fact, the promoter was dealing with himself. The promoter may avoid this danger by making full disclosure of all facts connected with these transactions to every person who has signed the stock subscription agreement, or by purchasing all of the stock himself, or by obtaining ratification by a vote of stockholders after the company has been completely established.

At the first meeting of the corporation, only a few shares of stock are issued to qualify the incorporators. These original stockholders should have paid for their stock It now becomes necessary, in order to launch the company as a going concern, to issue the stock authorized by the charter and any other securities, such as bonds or notes, which may be sold or issued in exchange for property. This authority to issue is granted by the stockholding incorporators and the directors.

LESS THAN 100 SHARES

NUMBER

SHARES

BLAW-KNOX

U.S. PAT. OFF.

INCORPORATED UNDER THE LAWS OF THE STATE OF NEW JERSEY

BLAW-KNOX COMPANY

THIS CERTIFICATE IS TRANSFERABLE IN THE CITY OF NEW YORK OR IN PITTSBURGH

This certifies that _______________ is the owner of

full-paid and non-assessable shares without nominal or par value of the CAPITAL STOCK of the Blaw-Knox Company, transferable on the books of the Company by the holder hereof in person or by attorney upon the surrender of this certificate properly endorsed. This certificate is not valid unless countersigned by the Transfer Agent and registered by the Registrar. This certificate is subject to all the terms, conditions and limitations of the Company's Certificate of Incorporation and amendments thereto to which reference is hereby made, with the same effect as if they were herein set forth in full.

Witness the seal of the corporation and the signatures of its duly authorized officers.

Dated

CAPITAL STOCK

REGISTERED:
THE CHASE NATIONAL BANK OF THE CITY OF NEW YORK
REGISTRAR
BY
ASSISTANT CASHIER

COUNTERSIGNED:
MANUFACTURERS TRUST COMPANY
TRANSFER AGENT
BY
AUTHORIZED OFFICER

SPECIMEN
SECRETARY

SPECIMEN
PRESIDENT

SECURITY BANK NOTE COMPANY

CHAPTER 5

CORPORATE CAPITAL STOCK

A corporation is an association of individuals authorized to own property, to contract debts, to appoint officers and agents, and to manage its business within the limits of its formal grant of authority by the state, known as its certificate of incorporation, or charter, as a natural person. The association owns the property The stockholders own the association The stockholders are represented in the management of the business of the association by directors. These directors, while transacting the most important business themselves, appoint administrative officers who carry on the work of business management.

Nature of Capital Stock

The ownership or property interest in a corporation is called the stock of the corporation The stock establishes the contractual relationship between the corporation and the stockholder From this relationship the rights of stockholders emerge

In order to effect the distribution of corporate ownership, the stock is divided into shares. The aggregate number of shares which a corporation is permitted to issue, is its "authorized capital stock"

It was long the practice to express the "authorized capital stock" of a corporation as a certain dollar sum, such as $100,000, $500,000, $1,000,000, or $10,000,000, etc. This sum is presumed to be equal to an amount of capital, that is, property or funds, which is turned over to the corporation to equip it for the transaction of its business The stock is not an asset of the company It is a liability or "accountability" of the company to its stockholders, and the amount issued is assumed to correspond to an equal amount of property value in the possession of the company The stockholders may pay into a corporation an amount greater than the amount of the authorized capital stock In such event, the excess is not considered capital stock, but paid-in surplus, and so appears on the balance sheet of the company The share of ownership belonging to each stockholder contributing to the capital of a corpora-

tion, is evidenced by a stock certificate, issued by the directors and signed by the officers. The corporation as a legal person is the owner of that fund of capital which has been contributed by shareholders for the purpose of starting the enterprise. The shareholders—stockholders—own the corporation

Unless, at a future date, the corporation should issue additional shares to obtain further sums of capital, or it reduces the number or the par value of shares originally issued, the capital stock remains the same Even though the capital used by the company may increase, should the corporation, during its operation, retain any profits earned, or should it increase its assets by any other means than the issue and sale of additional shares, such as the issue of bonds—the amount of capital stock is unchanged.

Par Value

Corporate shares may be issued either with or without a *par* value. Where the application for the charter requests an authorized capital of so many dollars to be divided into a specified number of shares, the par value is the result of the division of the authorized dollar figure by the number of shares requested. For example, if the authorized capital is to be one million dollars divided into ten thousand shares, the par value is $100 per share.

Stock Without Par Value

It is not necessary that shares of stock shall have a par value. In recent years, the states have generally authorized the issue of shares without par value When this method of issuing shares is used, instead of setting forth in the charter that the capital stock is $1,000,000 divided into 10,000 shares of $100 each, the incorporators seek the authorization of 10,000 shares without nominal or par value. In this case there is no monetary figure given for the capitalization of the company. In many states, however, the corporation law specifies a stated minimum capitalization, where no par shares are to be issued. Even though the corporation, in its application for the charter, does not name a dollar sum as its authorized capitalization, the state may desire to fix a minimum figure per share which, when multiplied by the number of shares issued, will represent the true capital stock of the corporation at the start of its life. The provision of this fund is necessary, in the eyes of the law, to secure

those persons who may advance money, property, or services to the corporation as creditors.

There is no necessary connection between the par value, or the stated minimum capital value per share in the case of no par value stock, and the market value of these shares. The market value of the shares depends primarily upon the profits of the company, and upon the portion of those profits which may be distributed in dividends by the directors. Its earnings, while dependent upon the amount of money or property contributed by the stockholders and creditors, and the sums reserved from profits, which together constitute the capital of the corporation, are also greatly influenced by the ability with which the property of the company is managed by the directors and officers, and by the strength of the demand for the product. With a going concern, the shares of stock may have, at any time, a market price per share which may differ widely from par, and a book value per share which can be determined by the process of calculating the net asset value of the business belonging to shareholders. This book value may again be different from either par value or market price.

Market prices are also influenced by the general business conditions of the country, and the condition of the industry in which the company operates. The market prices of all stocks suffered during the depression—some, of course, much more than others.

For all practical purposes, shares of stock without par value serve as well as par value shares. The holders of no par value stock receive dividends at the rate of a certain number of dollars per share. The percentage form in which announcement of a dividend on par value stock is usually made, is of no consequence. The holders of shares without par value can vote and participate in the proceeds of liquidation. All the rights of stockholders are theirs. If they desire to offer their stock for sale, their shares will be valued exactly as par value stock, on the basis of profits and dividends.

Rights of Stockholders

The rights of stockholders are as follows: First, the right to vote. A stockholder may vote (a) for directors of the company, and (b) on all matters of corporate policy which the statutes or the charter, or the by-laws reserve for the determination of the stockholder: for example, the sale of the property of the company, the amendment of the charter to permit

the issue of a special class of stock or to change the authorized capitalization of the company, the placing of a mortgage on the real property of the company, or the dissolution of the corporation

In large public corporations, the stockholders are so numerous and so widely scattered that it is not possible for many of them to attend meetings of the corporation The following table gives the geographical distribution of the shares of common and preferred stock which the United States Steel Corporation has issued and outstanding

DOMICILE OF REGISTERED OWNERS OF UNITED STATES STEEL CORPORATION

Common and Preferred Stock as of June 30, 1937

	Number of Shares	
Eastern States	*Common*	*Preferred*
Connecticut	103,177	129,979
Delaware	98,663	31,953
Massachusetts	389,932	254,051
New York	3,207,714	1,676,335
New Jersey	254,216	215,261
Pennsylvania	1,268,247	419,699
Others	129,092	88,302
	5,450,041	2,815,590
South Atlantic States	333,975	178,187
South Central States	243,182	48,376
North Central States		
Illinois	545,960	124,432
Michigan	113,078	35,221
Minnesota	143,234	45,475
Missouri	129,583	48,860
Ohio	308,689	65,997
Wisconsin	100,040	20,067
Others	173,907	18,245
	1,494,531	360,297
Western States		
California	284,545	87,065
Others	159,643	38,071
	444,188	125,036

MISCELLANEOUS	9,456	1,410
Canada	115,169	24,145
England	258,285	18,241
Holland	311,600	15,270
Others	42,825	16,269

It is manifestly impossible to gather together this army of investors into one place to deliberate on the affairs of the corporation. They must vote, if at all, by mail. The annual meetings of corporations are perfunctory and formal affairs by which the acts and decisions of the management are registered, in strict accordance with the law, but without any of the features which are commonly associated with the acts of a deliberative body. The following account of a meeting of one of the largest American corporations gives a vivid picture of the procedure at a stockholders' meeting.

"At the appropriate hour some 250 persons assembled in the offices of the company, out of more than half a million entitled to attend and vote. Even this corporal's guard seemed to be more than were expected, for there was some difficulty about seating them all. Of the 250, 36 were women, about 100 were gentlemen of middle and later age with "directors' stomachs," some 50 were lean young men who might have been university students coming merely to observe, and the remainder were Tom, Dick, and Harry stockholders even as you and I.

The president, a spare, efficient man, called the meeting gravely to order. The minutes of the previous meeting were read and approved without comment. The annual report of the directors, involving a construction program of $585,000,000, relationships with 400,000 employees in a year when employment policies were more widely criticized than at any previous time in history, and net earnings of $267,874,000—this report was referred to, and its adoption moved-seconded-carried without a single word of comment.

The next business was the election of directors. Printed ballots were distributed bearing the names of the existing directors with one substitution. The polls were solemnly declared open. The ever-careful president gravely asked whether every one had voted who wished to vote, and the polls were solemnly declared closed. The meeting was recessed for a few minutes while the ballots were counted. In about eight minutes the results were announced. The votes cast totaled 13,087,595. The vote for A was 13,087,595, for B the same, and so on for the whole 19 directors, all elected with this comforting unanimity. No one seemed in the least amused at the spectacle of three of the directors (those named in the proxies) giving themselves most of this over-

whelming vote, all without the owners of the stock so much as knowing who were up for election."[1]

When adjournment was moved, a corporation of half a million stockholders had approved its annual report, elected 19 directors, increased its capital stock by half a billion, and made itself perpetual—all in exactly 57 minutes. A total of 274,831,839 votes had been cast and counted, all of them affirmative except 178. In brief, the opposition amounted to the less than microscopic figure of six one-hundred-thousandths of one per cent.[2]

All of this, stated baldly, as this writer states it, is a highly humorous performance, and yet the situation presented by the enormous number of stockholders of these corporations, and their wide geographical distribution, could be handled in no other way than that indicated. Aside from those in attendance, each one of these stockholders who cast his vote did so by proxy. A stockholder's voting proxy is another person or persons designated in a written power of attorney signed by the shareholder registered as such on the books of the company, empowering him or them to cast the number of votes to which his stockholdings entitle him, either at their discretion, or for certain directors named in the power of attorney, or for or against certain corporate policies briefly described in the call for the meeting. An illustration of the form of proxy is as follows:

PROXY KNOW ALL MEN BY THESE PRESENTS, That the undersigned Stockholder in No.

The Pennsylvania Railroad Company

hereby appoints and constitutes W. W. Atterbury, Effingham B. Morris, Pierre S. Du Pont and J. Taney Willcox, as substitute and proxy of the undersigned, with full power to any one of them, in the name and behalf of the undersigned, to vote on any and all matters and questions which may come before the Annual Meeting of the said Company on Tuesday, the 12th day of April, 1932, or any adjournment thereof, and also to vote at the Annual Election by the Stockholders of said Company, for Directors thereof, or other purposes, on Tuesday, the 26th day of April, 1932, as fully and with like effect as the undersigned might or could do if personally present and

[1] It is now required, under provision of the Securities Exchange Act, that proxy notices contain the names of directors to be voted for, as well as the names of those for whom the proxy is solicited, e.g., the president.

[2] "Voting" Stock, by F. Emerson Andrews, *The Virginia Quarterly Review*, as condensed in *The Reader's Digest* for July, 1932.

voting thereat, provided such meetings and election occur within two months of this day

Witness	hand	and seal	this	day of	A.D. 1932

Witness

(SEAL)

(SEAL)

(SEAL)

The Signature must be witnessed Executors, Administrators, Trustees, Guardians, etc., will so indicate when signing

It will be observed that this proxy is a blanket power of attorney which authorizes the four men named to vote the stock of the signers at their discretion, in other words, to substitute any of these four directors for the stockholders who have signed the proxies It is not necessary that these delegated powers should be so broad. The request for proxies may be made by more than one group, and this always happens when there is a contest for control of the company In such a case, the rival factions carry on a spirited and often costly contest for proxies, placing before the stockholders their rival claims to the stockholders' franchises The "ins," who represent the management, officers, and directors, explain and justify their administration, and the "outs" attack and criticize the management. Typical contests of this kind which attracted nation-wide attention are the fights for control of the Illinois Central in 1907, the contest of the Crucible Steel Company in 1919, the contest over the Childs Company in 1929, and the famous contest for control of the Standard Oil Company of Indiana, carried on between Robert W. Stewart and John D Rockefeller, Jr In addition to the use of the mails, these contests are featured by a large amount of personal solicitation. In the Standard Oil of Indiana fight, and also in the Illinois Central contest, when Mr Stuyvesant Fish, president of the company, opposed Mr. E H Harriman, one of the directors, the newspapers remarked that the losing presidents were fighting a string of banks and trust companies, with all the manifold influence that these institutions could bring to bear on the holders of large blocks of stock

These contests, however, are few Their rarity makes them "big news" when they occur Ordinarily there is no contest. The management sends out letters requesting proxies The stockholders sign the

proxies inclosed and return them to the management The whole operation is perfunctory and formal

In corporate elections there is only one issue Has the record of the management been such as to entitle them to reelection? This record is expressed in figures of earnings and profits, of assets and liabilities, of production and sale. It is presented in detailed annual, or more frequent reports which every stockholder receives. Newspapers currently report matters of public interest arising out of corporate developments. For example, the labor controversies, now a prominent feature of corporate management, are daily reported in the press, and stockholders, who are almost universally newspaper readers, are now familiar with the management of these affairs

Proposals to issue securities are usually announced in advance The amount and description of the securities, and the purposes to which the funds are to be devoted are given wide publicity New industrial developments in corporate life are announced and explained Recent examples are the manufacture of synthetic fibers from coal-tar by the Du Pont Company, the manufacture of synthetic "rubber" by the same organization, the developments in building-glass by the Owen-Illinois Glass and the Corning Glass Company, the phenomenal expansion and improvement in the manufacture of rayon, the continuous rolling process in which vast sums have recently been invested by the steel companies, and the shift of kraft paper manufacturing, with yellow slash pine as the raw material, to the southern states. The newspapers abound with information of this character Any stockholder, by regular perusal of any first-class financial newspaper, obtains a continuous record of the history of the companies in which his money is invested

It is true that corporate elections are conducted by holders of powers of attorney, and that the stockholders themselves do not usually direct, in these powers of attorney, the voting of their shares. But this does not argue either apathy or ignorance on their part On the basis of information given, they are satisfied that the affairs of their companies have been well administered, that the management is deserving of confidence The stockholder is interested in dividends, and, incidentally, in the maintenance of the value of his stock As long as dividends are forthcoming, or even when dividends are suspended, when he receives full information on the causes of their suspension, when the management holds nothing back, and keeps him posted as to the affairs of his com

pany, experience has shown that stockholders will perpetuate directors in office

In further and final elaboration of this point it should be remembered that American railroad companies, which have generally suspended dividends since 1931, are still, with few exceptions, managed by the same men, if these men are still living and below the retirement age, who were in control during the golden years before the stock market crash of 1929 The stockholders understood that the country was in the midst of a business depression They saw the earnings of their corporations decline to very small figures. They knew that dividends could not be paid They had confidence in the management.

The institution of corporate elections has attracted the interested attention of reforming publicists and politicians. For many years, large corporations have been the targets of political attack, especially those companies whose operations touch the lives of the entire population, such as railroads and other public utilities These companies employ the greater part of the working force of the country in transportation, mining, and manufacturing. Controversies about wages, hours, and working conditions are a perennial source of popular unrest and criticism. Corporations are heavy taxpayers, and they are often before the legislatures and in the press, attempting to reduce their tax burdens In recent years they have taken no direct part in politics. Long gone are the days when corporations "owned" members of the United States Senate and the House of Representatives, when judges and members of state legislatures traveled on annual passes, when companies contributed directly to campaign funds, and when the entire membership of a state senate would be individually tagged with the label of one or another corporation. In spite of the removal of corporations from direct participation in public affairs, however, stockholders, directors, and officers, as individuals, are not unmindful of the influence of political developments upon the earnings of their companies

Out of this situation, has arisen a continuous and almost nation-wide controversy between the representatives of the public and the representatives of the corporations It is believed by many political critics, in good faith and with all sincerity, that if the control of these companies, by a rearrangement of the machinery of election, could be restored to the stockholders, especially if the small stockholder could be more fully informed as to corporate affairs, and if the way could be opened to him

to express his opinions in corporate elections, certain abuses—particularly those which are grouped under the general heading of the exploitation of the stockholder—could be prevented A complaint which was common during the twenties concerned the disenfranchisement of the stockholder. At that time, a very large amount of stock was issued, especially by public utility holding companies, which was non-voting. Some of these holding companies were already guilty of gross mismanagement, as the result of which the stockholders suffered heavy losses. A campaign was started by Professor William Z. Ripley, in a series of articles in *The Atlantic Monthly*, which were later published in a book entitled *Main Street and Wall Street.* In this volume, Professor Ripley explained in detail how powerless were the stockholders in a number of large companies, because they had no right to vote for directors As a direct result of Professor Ripley's criticisms, the New York Stock Exchange announced that it would give careful thought, in considering future applications for listing of stock, to the matter of voting control and, in fact, has since discouraged attempts to list non-voting stock

The protection of the minority has long engaged the attention of the reformers. It is believed that the majority have often exploited the minority, particularly where the majority interest in the company is controlled by a few individuals, and when the minority interest includes a large number.

The Securities Exchange Act of 1934, administered by the Securities and Exchange Commission, deals at length with this matter of proxies. The framers of the law evidently considered that the method of soliciting proxies was open to the following objections first, that the purpose of the call for proxies was not clearly presented to the stockholders, second, that the names of the proxy holders and the positions held in the company by the persons in whose names the proxies were solicited were not clearly understood, third, that the proxies might be obtained in such form and under such conditions as to provide blanket endorsement from the stockholders of past acts and projected policies which, if the facts were fully disclosed at the time the proxies were solicited, might influence stockholders to withhold their proxies, and fourth, the lawmakers believed that the proxy system, as then administered, was used by the management to perpetuate themselves in control of their corporations, since stockholders were given no adequate information or suitable machinery by which to make a change in management if they so de-

sired. The regulations of the Securities Commission which apply, be it noted, only to companies listed on some recognized exchange, aim to meet these objections.

The new rules, briefly summarized, provide

1 If the solicitation of a proxy is on behalf of the management, it must be so stated in the request for proxies

2 If there has been filed with the company, not less than twenty days prior to the date of solicitation, a written statement by any director or directors that he or they oppose solicitation by the management, and that he or they propose to solicit proxies from holders of 25 per cent or more of any class of stock, it must be so stated

3. If the solicitation is initiated otherwise than by or in behalf of the issuer, the names of the persons initiating the solicitation, the class or classes of stock which are owned by them, and the amount of stock so owned, must be stated

4. If the solicitation is by a person engaged for compensation to recommend the execution of the proxies, a statement naming the person or persons in whose behalf such solicitation is being made must be indicated

5 A brief description of the various matters, actions, or transactions which it is intended to consider in the exercise of the proxy, and the action which it is intended shall be taken by the holders of the proxy, must be given

6 It is required that a sufficiently detailed financial statement accompany the solicitation for proxies (This information may be contained in the pamphlet report of the company which is usually furnished to stockholders once each year, or in the proxy notice itself, if meetings are held between annual meetings)

These rules do not apply to proxy solicitation by (a) any bank, dealer, broker, or nominee in respect of securities carried in its name, where no commission or remuneration is paid directly or indirectly to it for such solicitation, (b) to solicitations by any custodian of securities held in its custody where no commission is paid, (c) by any trustee other than a voting trustee or trustees of a business trust in respect of securities of which he is trustee, (d) by any person in respect of securities of which he is the beneficial owner, and (e) by any person whose activity is limited to the performance of ministerial acts on behalf of a person who is soliciting a proxy

These regulations aim to prevent the worst abuses of the system of proxy voting. They require the disclosure of the identity and interest of the intended proxy holder. They give dissenting interests in the board the opportunity to solicit proxies. They require the disclosure of full information to the stockholder, on the basis of which he may give or withhold his proxy.

Even before these regulations were promulgated, the New York Stock Exchange, in addition to discouraging the listing of non-voting stock, had made an important reform in the solicitation of proxies obtained from stock brokers. A large amount of such stock is frequently in brokers' offices as collateral for brokers' loans and standing in the brokers' names. Brokers depend upon banks to furnish them the money to carry on their business. Banks are friendly with corporation directors and officers who direct the large deposits of the companies this way or that. Where these brokers' proxies are desired by the company, an intimation from the bank where the broker carries his account that it would be a favor to them if the proxies were furnished, is all that is required to produce them. An individual stockholder or group of stockholders without these financial affiliations would have small chance to get these brokers' proxies. Under a recent regulation of the New York Stock Exchange, brokers are required to advise the owners of the stocks held in their offices of the request for proxies and to request instruction. If no instructions are furnished, the broker is free to vote the stock as he wishes.

So far as the law can enforce the provisions of full information as a basis for stockholders' action, the Securities Exchange Act has provided for this information. It is a question, however, whether most stockholders will be greatly influenced by the formal compliance with these regulations. They have been in effect for some years, and there has been no evidence of any change in the constant support which stockholders have given to corporate managements. So far as information is available, even in those cases where the existence of gross abuses of proxies, powers, and responsibilities have been disclosed, stockholders have not shown themselves much interested in making possible by their votes desirable changes in management.

The management of certain large public utility holding companies, for example, has been exposed by the Federal Trade Commission as guilty of a variety of mistakes of omission and commission, rising in

some cases to the point of serious offenses, and including, among other things, the use of their power over the companies making up the system to collect enormous revenues from excessive service changes. These managements, however, are still in full control These cases, as already stated, are rare and exceptional, and they have not sufficed to arouse the general stockholders' interest in and criticism of management, which the new proxy regulations were supposed to promote.

Regulation for Benefit of Minority

The next group of regulations intended to improve the position of the stockholder relates to the minority stockholder The law and the practice of American corporations favors majority rule In corporate elections in the absence of some provision to the contrary, if 51 per cent of the outstanding stock votes for a given board of directors, those directors are elected The same majority, unless limited in the charter or the statute, is sufficient for any corporate act requiring the approval of the stockholders This situation gives the majority power to exploit the minority. Especially is this true in the case of intercorporate holdings where one company owns other companies through which it sells merchandise, or from which it buys its raw materials In such cases, there is a divided interest A railroad company, for example, which owns a controlling interest in the stock of a connecting line, is more interested in routing traffic from the connecting line over its own line, than it is in earning dividends for the stockholders of the connecting line A company owning a controlling interest in a coal- or iron-mining company may be more interested in securing cheap coal and iron ore, than it is in earning dividends for the stockholders of these supply companies. Their profits are made from the business arrangements which this control makes possible. The dividends on their investments in these subsidiaries is of relatively small concern to them

These intercorporate relationships, when established in the field of interstate commerce, are subject to various controls. The Interstate Commerce Commission passes on the fairness of traffic interchange contracts, and on the issue of securities by which one company gains control of another. The Federal Trade Commission passes on cases where monopolies antagonistic to the public are established by these intercorporate holdings

In the public utility field, under the Public Utility Act of 1935, the

Securities and Exchange Commission is given the authority to protect minority stockholders of registered companies against abuse and extortion, particularly in the matter of excessive service charges by their corporate parents. From all of these regulations and controls, minority holders benefit

Aside from expanding the area of public control of corporate activity, however, little has been done by statute to improve the position of minorities. Effective resistance to such abuses may be made by minority stockholders, if they care to undergo the trouble and expense, by invoking the aid of courts of equity, or courts of law

Cumulative Voting

A more familiar restriction on the power of the holders of the majority stock undertakes to secure for the holders of the minority a sufficient representation on the board of directors to enable them to know what is going on, so that they may act promptly if their interests are endangered by any act of the majority directors This method of protecting the rights of the minority is known as cumulative voting It is described in Section 505 of the Pennsylvania Corporation Laws of 1935 as follows

> Unless otherwise provided in the by-laws, elections for directors need not be by ballot, except upon demand made by a shareholder at the election and before the voting begins In all elections for directors every shareholder entitled to vote shall have the right, in person or by proxy, to multiply the number of votes to which he may be entitled by the number of directors to be elected, and he may cast the whole number of such votes for one candidate or he may distribute them among the two or more candidates. The candidates receiving the highest number of votes up to the number of directors to be elected shall be elected.

Suppose, for example, that there are 100 shares of stock outstanding and five directors to be elected. The holder of 20 shares of stock may vote as follows when cumulative voting is provided He may cast 20 votes for Directors A, B, C, D, and E, or, in case he finds himself in the minority and desires to secure the election of at least one director who will represent his interests and keep him posted, he may elect to cast 100 votes, which equals the number of shares he owns, times the number of directors to be elected, for Director E, or he may cast 50

votes for E and 50 votes for C When cumulative voting is provided, it is impossible for a stockholder owning a number of shares in relation to the total number of voting shares, which, when expressed in a fraction, is equal to one over the number of directors to be elected, to be denied representation on the board. He is certain to provide a clear majority for his candidate.[8]

Another method of voting, which has long been in use for the same purpose, provides for weighting the vote in proportion to the number of shares owned by each stockholder For instance, the charter may provide that the ownership of one share of stock entitles the holder to one vote, but this rule can be modified in any way that the incorporators may desire. They may provide, for example, that one share equals one vote up to 100 shares, from 100 to 200 shares, two shares equal one vote, and from 200 to 500 shares, three shares equal one vote, the purpose being to reduce the voting weight of large stockholders.

The Voting Trust

Another device frequently used for the protection of the minority stockholder's interest is the voting trust An individual stockholder, who may own 1/10,000 of 1 per cent of the total stock, is a helpless atom in a vast aggregate. If the majority wish to take advantage of their position to his disadvantage, he has neither the knowledge nor the strength to oppose them. Like the individual employee of the United States Steel Corporation or the General Motors Company, by himself he is helpless. When he is joined together with his fellow workmen, or with his fellow stockholders, however, the individual becomes armed with effective weapons against abuse and exploitation In the voting trust, the stockholders convey title to their shares to trustees, receiving in return certificates of beneficial interest in the stock and in any dividends which may be declared upon it The trustees, along with

[8] For greater accuracy, the following formula is used for determining the least number of shares required to elect one director $x = \frac{a}{b + 1} + 1$ in which x equals the required number of shares, a equals the entire number of shares and b equals the number of directors to be elected To determine accurately the least number of shares required to elect all directors, the following formula may be used $x = \frac{ab}{b + 1} + 1$ with the same equivalents as above

title to the shares, have the voting rights of the shares. By combining a large amount of stock—representing the share holdings of many stockholders—in the hands of trustees, each small stockholder has the same protective representation that the large stockholder has. As a stockholder, his interests are supposed, as we shall see, to be protected by the directors. But the directors are elected by the majority, and, in effect, represent the majority. The directors, moreover, are directors of the corporation and are not trustees of the stockholders of the corporation. The trustees of a voting trust, on the other hand, are charged with the heavy and manifold responsibilities of a fiduciary. The stockholders in a voting trust are *cestui-que-trustents*. *Cestui-que-trust* is defined as "he who trusts another," and the law is very exacting in reference to the responsibility of a trustee. A trustee must always place the interest of the *cestui-que-trust* above his own interest. He must protect the interests of the stockholders at all times, and with an eye solely to their advantage. It is to be hoped that, as stockholders gain greater acquaintance with this institution, its use, which up to the present time has been mainly confined to the concentration of stock for purposes of sale, and to the protection and perpetuation of creditors' control in a reorganization in which they have been obliged to take stock in place of their bonds, will lead to an expansion of the voting trust, which, when properly set up, can serve very effectively to protect the interests of even the smallest stockholder.

Stockholder's Right To Be Faithfully Represented

Stockholders have the right to faithfully represented by directors At the same time, the directors are not agents of the stockholders, and they are not "trustees" for the stockholders Their responsibility to the stockholders is an indirect one. Their direct responsibility is to the corporation which the stockholders own. A stockholder may, it is true, sue a director for breach of trust, but he sues on behalf of the corporation and the stockholders of the corporation, and not on his own sole behalf. Corporate directors are, however, held to a high degree of accountability. This is "a result of their dominant position, growing out of the complete control accorded to the board in the management of corporate affairs, the expenditure of entity's (corporation's) funds, and the disposition and use of its assets. It has been well said that 'the corporation is the owner of the property, but the directors in the perform-

ance of their duty possess it, and act in every way as if they owned it.' "[4]

The relationship of the director to the corporation is therefore a fiduciary relationship, because of the large powers over the corporation's property and business which are placed in the directors' hands. The distinction between a trustee for the stockholders, and a trustee for the corporation, is not substantial It all comes to the same thing in the end, that directors must exercise the utmost good faith in all of their dealings with the corporation. What does good faith mean? In the first place the directors must take no advantage of any position where their interest is adverse to that of the corporation For example, a director of a railroad company which controls the stock of a coal company, must not take advantage of his position as a director to obtain preferential treatment for the coal company in prices or quotas He must not, without the consent of the stockholders, expressed or implied, be a party to any contract with the corporation. Such a contract is known as a voidable contract, and within a reasonable time the contract, at the suit of a stockholder, may be annulled, always providing that the other party is placed in the same position as that which he occupied before the contract was entered into If, for example, a director of a corporation should lease a piece of real estate to the corporation, and after the matter was made known, a stockholder should petition a court of equity for the annulment of the lease, alleging valid grounds for his action, he would obtain the relief prayed for, provided that any buildings or other improvements on the property which would interfere with its use by the owner after the lease had been terminated, should first be removed at the expense of the lessee (tenant corporation).

Directors must answer to stockholders not only for acts of commission, but for negligence in caring for the interests of the company committed to their charge These obligations of directors are very real obligations, and are taken seriously by honorable men James J. Hill, for example, who was a director of the Great Northern Railroad Company, in a transaction carried out for the benefit of his company in connection with the purchase of ore lands, refused a profit of at least $20,000,000 which he could easily have made, and turned this profit over to the stockholders of the Great Northern. As a stockholder, he properly shared in this profit to the extent of his holdings As a director,

[4] Spellman, H H, *Corporate Directors*, p. 15

however, he did not profit. On the witness stand, when questioned about this transaction by an importunate and obtuse congressman, he summed up in a brief sentence the whole duty of a man on a board of directors "I felt it worth my while to have clean hands." It would have been legal for Mr. Hill to retain a large profit on the Great Northern ore lands transaction The action taken in this case was in the effort to avoid even the appearance of suspicion of bad faith to the stockholders and was at the time so regarded.

Directors must act as a board They have no official existence outside the board room. One director can not bind the corporation Furthermore, a director-stockholder has no greater obligation to his fellow-stockholders because he is a director. He is not even prohibited by law, although he may be deterred by what may be termed, for want of a better phrase, corporate ethics, from utilizing the information which he may obtain at board meetings for his personal profit.

The authors know of a case in which a consolidation of two banks was pending, a fact unknown to the mass of stockholders, which was certain to add to the value of the stock concerned The president of the larger institution, the late James N Wallace, of New York, did not purchase any stock although, by so doing, he could have made a large profit. In refusing to increase his holdings, Mr. Wallace, just as Mr Hill, was keeping his hands clean. On the other hand, there is a well-known case which at one time was brought to the attention of the Federal Trade Commission by the stockholders, in which the Commission could not take jurisdiction, which involved the following set of circumstances A company was making large profits, and its prospects were extremely favorable. A large competitor wished to acquire all of the common stock of this company. It gave a written agreement to the president of the company, who was also a director, promising to pay him a very high price, if he would sell them substantially the entire common stock. The director owned a majority of the common stock, but several years before, hard-pressed for money as a result of the depreciation in inventory in the depression of 1920-21, he had solicited a number of his friends to buy an issue of preferred stock in his company which carried with it a bonus of common stock. The common stock had paid no dividends, but dividends had been regularly paid on the preferred With the offer from the large company in his pocket, he went to his friends who had so loyally, and to themselves profitably, supported his interests, and

informed them that he had always been anxious to show his appreciation of the great service which they had rendered him, and he was now prepared to take the common stock off their hands at a substantial advance over the market price. They joyfully accepted his offer, and thus enabled him to take advantage of the offer which he personally had for the resale of the stock, which, it was reported, netted him a large profit.

This action, when it was made known to the stockholders who had sold their stock, infuriated them. They sought legal advice on the feasibility of recovering from the president of the corporation, the profit which he had made at their expense. The advice was, however, that the president's action, while, to say the least, in bad taste, was not unlawful. In purchasing this stock, he acted not as a director nor as an officer of the company, but as an individual stockholder, and it is a well-settled maxim of corporation law that one stockholder owes no duty whatever to his fellow-stockholders One stockholder deals with other stockholders at arm's length. To him they are strangers.

Corporation directors are charged with the duty of full disclosure to stockholders of facts relating to the business of the corporation, knowledge of which is necessary to enable them to determine whether they should retain their stock, increase their holdings if opportunity offers, or sell their stock and withdraw. This obligation does not extend to the disclosure of facts which might be damaging to the company's business. It does not cover, for example, information about the details of contracts, either within or without the company, or the scale of salaries paid, or the terms of traffic agreements between one railroad and another, or the interest paid on bank loans, or the banks in which the company's funds are deposited, or the prices paid for raw materials, or the arrangements with advertising agencies, or, in general, any of the details of business management, which it is necessary to keep secret. Information which the stockholders are entitled to receive is the income account and balance sheet of the company, and an explanation of any substantial changes from one year to another in the items of these accounts.

American industrial corporations, following a practice which started with the first report of the United States Steel Corporation, have steadily increased the amount of non-confidential information which they furnish their stockholders. This is provided by monthly or quarterly statements of earnings, by published statements given to the press on impor-

tant matters of corporate policy, by occasional letters to stockholders, especially when it is desired to prepare their minds for action at some later meeting, and in the pamphlet reports which, with many corporations, have grown to very substantial size A good illustration of a modern corporation report is the pamphlet report of the General Motors Corporation for the year ending December 31, 1939 This begins, after some general observations as to the responsibility of the company to the different interests dependent upon it, with a detailed financial review of the year's operations, showing the changes in the balance sheet and in the income account There were no changes in the capitalization during the year. Follows an operating review showing the sales of cars in different markets with a special emphasis on the increases of foreign sales It also shows the sale of each make of car The company also explains the improvements which have been made in its collateral lines, such as Frigidaire, General Motors Acceptance Corporation, and aviation The report gives the average working hours per week, the average hourly wage rate, and the annual earnings per worker. It discusses the compensation of executives, the tax bills paid by the company, the bonus plan under which executives' salaries and employees' wages are supplemented, and the employees' special investment plan This report is supplemented by an appendix, giving the details of the various accounts, the record of earnings from the beginning of the company, the record of dividend payments and stock changes, the pay-rolls, the number of employees, and the number of stockholders.

We question whether all this information—and this is not the largest of the corporation reports—is of any great benefit to the stockholders, unless by particular training they are qualified to make a comparative analysis of the financial information contained in the reports. These comprehensive reports are creators of goodwill They strengthen the confidence of the stockholders in the management, insofar as the stockholders read them Unless the management attempts to becloud or confuse the report by improper presentation of financial information, these reports should increasingly improve the stockholder's knowledge of and interest in the company in which his money is invested

There have been unfortunate and notorious cases of misrepresentation contained in stockholders' reports. One of the early cases of this character was the famous "surplus" of the Baltimore and Ohio Railroad. This company in 1893 reported a surplus of $25,292,085. The surplus

was created by inflating the book value of the assets of the company beyond their reasonable value. This form of misrepresentation has frequently cropped out in corporation reports. Another type of misrepresentation is that reported by Graham and Dodd as follows

On comparatively rare occasions, managements resort to padding their income accounts by including items in earnings, which have no real existence Perhaps the most flagrant instance of this kind which has come to our knowledge occurred in the 1929-1930 reports of Park and Tilford, Inc., an enterprise with shares listed on the New York Stock Exchange. For these years the company reported net income as follows

1929—$1,001,130 = $4 72 per share
1930— 124,563 = 0.57 per share

An examination of the balance sheets discloses that during these two years the item of Good-will and Trade-marks was written up successively from $1,000,000 to $1,600,000 and then to $2,000,000, and these increases *deducted* from the expenses for the period. The extraordinary character of the bookkeeping employed will be apparent from a study of the condensed balance sheets as of three dates, September 30, 1929, December 31, 1929, December 31, 1930.

These figures show a reduction of $1,600,000 in net current assets in fifteen months, or $1,000,000 more than the cash dividends paid. This shrinkage was concealed by a $1,000,000 write-up of Good-will and Trademarks. No statement relating to these amazing entries was vouchsafed to the stockholders in the annual reports, or to the New York Stock Exchange in subsequent listing applications In answer to an individual inquiry, however, the company stated that these additions to Good-will and Trade-marks represented expenditures for advertising and other sales efforts to develop the business of Tintex Company, Inc , a subsidiary.

The charging of current advertising expense to the good-will account is inadmissible under all canons of sound accounting To do so without any disclosure to the stockholders is still more discreditable It is difficult to believe, moreover, that the sum of $600,000 could have been expended for this purpose by Park and Tilford in the *three months* between September 30 and December 31, 1929 The entry appears therefore to have included a recrediting to *current* income of expenditures made in a *previous period*, and to that extent the results for the fourth quarter of 1929 may have been flagrantly distorted Needless to say, no accountants' certificate accompanied the annual statements of this enterprise.[5]

[5] Graham and Dodd, *Security Analysis* (McGraw-Hill Book Company, Inc., New York, 1934), pp. 372 and 374.

We shall, in a later chapter, discuss in more detail the forms and method of presenting financial statements to stockholders Suffice it to say at this time that such instances as those mentioned, where false information has been given to stockholders in the published reports, are exceptional In general, large public corporations are careful to give only correct information, and in recent years very copious information, to their owners.

In concluding this section, it should be noted that stockholders are interested in the composition of the board of directors They look to the directors to manage the affairs of their company. For this management, detailed knowledge of the business of the company is not necessary. This knowledge is not possessed by any persons except the officers Large stockholders whose interest in the company is so great as to warrant their giving much of their time to the management of the company's affairs, may act as directors. No doubt also, the presence on a board, of men of large affairs and diverse business interests, whose sound judgment has been proved by their individual success, is of benefit to the corporation in matters of general policy which transcend the details of the particular business in which the corporation is engaged Such matters are the proper handling of labor disputes, the attitude toward the provision that the corporation must register with the Securities and Exchange Commission for the purpose of submitting itself to detailed regulation, or the best way in which to raise a large sum of money for the expansion of the company These are matters upon which the officers of the company may not be particularly well informed, and they welcome the advice of directors whose experience fits them wisely to decide such questions

When, however, the directors have to decide whether to spend a large sum upon replacing the equipment of an electric railway company, or the addition of a new unit to a chemical company, or the addition of a new line of products which may increase the company's earnings, the only directors competent to advise upon such matters are those members of the board who are directly concerned with the detailed business of the company The outside director, under these circumstances, has only general knowledge. He is apt to consider such questions from the narrow standpoint of the immediate effect on the earnings of the company, rather than to take a long view of its permanent welfare In deciding such questions, if directors are enlightened, they commonly

rely upon the considered recommendations of the management. Aside from a general limitation on expenditures, they do not presume to pass judgment on matters with which they have only a superficial acquaintance.

Another aspect of the same problem concerns the stock position of directors. Should the board be composed of the larger stockholders? This is not the practice among American corporations. Directors, generally speaking, are not selected because of the size of their holdings, but because of the opinion of the existing members of the board, of the strength which their inclusion will bring to the company. In fact, it has sometimes occurred that it is a handicap to a company for a director to hold a large stock interest.

A manufacturing company had been moderately successful under the management of a large stockholder. In 1933 this company had built up a very efficient research department which cost it about $500,000 a year. Over ten years, the total cost of the research department had been $5,000,000. In this period, the increased net profits which could be directly traced to the discoveries and improvements coming out of the research department, amounted to $34,000,000. The stockholding executive, however, was not impressed by this showing. He saw the earnings reduced during the depression, and his dividends suffered with the earnings. He demanded drastic economies, as a result of which the outlay for research of this organization was reduced from $500,000 to $150,000 annually, and the research organization was largely broken up and many of its most valuable members were forced to seek other employment.

Here appears the vice and danger of large stockholder directors. Such men are apt to look to the immediate return. A policy such as that successfully pursued for many years by the General Electric laboratories under W. R. Whitney, which was nothing less than power laboratory research without thought of immediate profit, under the direct supervision of such men as Steinmetz and Coolidge, but which has, nevertheless, resulted in enormous profits to the company, is seriously handicapped by directors' emphasis upon immediate return. It is to the credit of John D. Rockefeller, Sr., that, in spite of his enormous holdings in the Standard Oil Companies, as long as he retained his active interest in the business, he always favored large expenditures for research.

The foregoing criticisms of the adverse interests and the short-sighted views of large stockholder directors, support an idea frequently expressed that directors should be hired and paid a salary commensurate with the work done. In effect, an active director should be looked upon as an officer of the company In America directors are presumed to serve without compensation, except a nominal director's fee of \$2, \$5, \$10, \$25, or \$50, according to the size of the company, and the value of the time of the director These directors' fees, while small, are nevertheless highly valued by their recipients. They are effective in securing a full attendance.

The American director's fee is not adequate compensation for the amount and quality of the service that should be expected. American corporation law, in fact, makes no provision for salaries to directors as such, unless the charter and by-laws provide for it, which they seldom do Writers on corporation finance have sometimes spoken approvingly of the greater responsibility of the directors of British corporations It is claimed that the British director is more devoted in his service to the company than the directors of many American corporations The compensation of directors is, on the whole, somewhat higher than in the United States British stockholders often show their appreciation of the efforts of the directors by awarding them substantial bonuses when they have had a particularly good year. This is not, however, a difference in the machinery of administration, but a difference in standards of business ethics The British business man practices on a much higher ethical plane than does the American He takes his responsibilities, both in civic life and in business life, very seriously He is held by public opinion to a rigid accountability The conviction in 1931 of Lord Kylsant, one of the foremost business men in England, on the charge "that he as a director of the Royal Mail Steam Packet Company, published a prospectus which he knew to be false in a material particular, inviting subscriptions to a debenture issue, with intent to induce persons to subscribe or advance money to the company, contrary to Section 84 of the Larcency Act of 1861," [6] and his sentencing to a year in jail as a penalty, shows how far the British standard excels our own.

Some years ago a firm of private bankers in England failed, not because of any act which might be considered criminal, but because

[6] Reis, Bernard J, *False Security* (Equinox Cooperative Press Inc, 1937), p 233

of a number of bad loans They were indicted for mismanagement, and the court held that they had shown themselves criminally careless, although they had not personally profited from the proceeds of these loans. These bankers received sentences of eight years in jail If the British standards were applied in the United States, especially to American bankers, it is greatly to be feared that many eminent pillars of American society would now be serving long penal sentences In the United States an offence of this kind, as one prominent financier, recently testifying to a bad loan of over $40,000,000, said, "a serious error of judgment," and let it go at that.

Stockholder's Rights to Share in Profits and Assets in Liquidation

The two most important rights of stockholders are the right to share in profits and in the proceeds of liquidation, should it become necessary to wind up the company and convert its assets into cash These are the primary objects of the stockholder The first, the right to receive dividends, in fact, represents his sole direct interest in the company He may acquire an interest in a corporation for the purpose of strengthening the position of another corporation, but generally speaking the millions of stockholders in American corporations are concerned only with what they get out of it

The payment of these dividends is a matter for the discretion of the directors This directors' power over dividends will be fully discussed in a later chapter The participation of stockholders in the proceeds of liquidation is, however, a matter of right, governed by the law and controlled by the provisions of the contracts between the various classes of stock, the creditors, and the corporations.

CHAPTER 6

PREFERRED STOCK

Frequently a business corporation can not be financed through the use of one kind of stock. In cases where appeal is made to the public to supply funds, a more elaborate financial plan is generally required, dividing the stock into two classes—preferred stock and common stock.

The Nature of Preferred Shares

If a company decides to use only common stock, and issues 50,000 shares, the owner of 5,000 shares is the proprietor of one-tenth of the corporation In the absence of some special provision to the contrary, he casts one-tenth of the votes If the directors declare a dividend out of the profits of the company he receives one-tenth of the amount paid. If the sum distributed in dividends is $50,000, the holder of 5,000 shares would receive $5,000. If the company is dissolved, and its assets bring $500,000 after payment of debts, the holder of 5,000 shares would receive $50,000 This would be true, no matter what the amount of the capitalization of the company might be, or into how many shares it might be divided Whether the stock capitalization is $5,000,000 or $50,000, or the par value per share $100 or $1, the position of the individual stockholder in participation in dividends and in assets is the same

When, in addition to common stock, preferred stock is issued, two classes of owners are created (1) preference shareholders, who receive a certain rate of dividends, say 5 per cent on the par value, or five dollars per share if it is no par value stock, which must be paid them out of the profits distributed before the holders of the common stock can receive any dividends, and (2) common stockholders who are entitled to what is left after the claims of the preferred stockholders have been satisfied The advantage of preferred stock is that the owner has a prior claim upon the profits of the company, a claim inferior, it is true, to that of the creditors, but superior to that of the common stockholders. If the profits of the company are only enough to pay the stated dividend on the outstanding preferred shares, and in case the directors

decide to distribute these profits, the preferred stockholder will receive all the dividends distributed, while the common stockholder will receive nothing.

Participating Preferred Shares

It may, however, be provided in the contract between the corporation and the holders of its preferred stock, that, until a certain additional amount of return to the preferred stockholders has been paid, they shall participate equally with the common stockholders in any distribution of profits To illustrate, assume a corporation with $1,000,000 of 7 per cent participating preferred stock, and $1,000,000 of common stock outstanding, with $180,000 of profits to be distributed, and the maximum return to be received by the preferred stockholders fixed at 10 per cent. The preferred stockholders would first be paid the specified dividend of 7 per cent, or $70,000. The remaining $110,000 would be divided equally until the preferred stockholders received 3 per cent or $30,000 additional The common stockholders have received 3 per cent while the preferred were receiving their extra 3 per cent. The remainder of the amount to be distributed, $50,000, would also go to the common stockholders Thus, the 7 per cent preferred stockholders would receive 10 per cent, or $100,000, and the common stockholders 8 per cent, or $80,000

It may be provided that participation of the preferred stock with the common stock shall begin after a certain dividend has been paid on the common stock, when both classes of stock are to share equally in profits Assuming the same capitalization and profit as above, the distribution of the profits would be as follows· on the preferred stock would first be paid the specified 7 per cent, or $70,000, on the common stock would then be paid, let us say, 7 per cent, $70,000, although it might be more or less than the fixed rate on the preferred, and the remaining $40,000 would be shared equally among the holders of both classes of stock, each class receiving an additional 2 per cent, or $20,000, a total of $90,000 or 9 per cent.

The participation of the preferred stock with the common stock may be unlimited from the beginning Again using the figures mentioned above on the preferred stock would first be paid 7 per cent, or $70,000; the remaining $110,000 would be divided equally between preferred and common stock, each class receiving $55,000 of this amount, or a

dividend of 5½ per cent. This plan of participation would result in the payment of \$125,000, or 12½ per cent to the preferred stockholders, and \$55,000 or 5½ per cent to the common stockholders.

Cumulative and Non-Cumulative Preferred Stock

Preferred stock may be classified into non-cumulative and cumulative, depending upon the stipulations in the charter contract, concerning the obligation of the company to pay a specified rate of dividend for every year during which the preferred stock is outstanding This obligation may be expressed as follows "The holders of the Five Per Cent Profit Sharing Preferred Stock A of the Company shall be entitled to receive preferential dividends in each fiscal year up to the amount of 5 per cent before any dividend shall be paid upon any other stock of the Company, but such preferential dividends shall be non-cumulative," the statement means that, subject to the declaration of dividends out of profits by the directors, the maximum amount to which the preferred stock is entitled in any particular year is 5 per cent, and if, in any year, the 5 per cent, or any portion thereof, is not paid, the amount remaining unpaid is lost This is true even though the profits earned in a particular year may be sufficient in amount to provide for the unpaid preferential dividends

When the net profits of a corporation out of which a dividend might have been declared for the preferred stock are justifiably applied by directors to capital improvements, the claim of the stock for that year is gone, if by the terms of the articles of incorporation and the certificates the preferential dividends are not to be cumulative The fact that there were profits in that year out of which dividends might have been (but were not) declared does not entitle such stock to a correspondingly greater preference over other stock when the profits of a later year are to be divided [1]

If the stipulation as to the obligation of the company to pay dividends on the preferred stock is couched in language containing the following statement, "The dividends upon the preferred stock shall be cumulative, so that if, in any year, the dividends amounting to 7 per cent per annum, are not paid on the preferred stock, the deficiency is payable subsequently before any dividends are set apart or paid on the common stock," it is said to be cumulative. If the earnings of a corporation in

[1] Wabash Railway Company v Barclay, *United States Reports*, Vol 280, p 197

a certain year are only sufficient to provide for the distribution of $1,000,000, while the dividend on the 7 per cent preferred stock requires $1,600,000, there is a $600,000 deficiency. In the following year, assuming earnings to be $2,200,000, the preferred stockholders in addition to their regular dividends of $1,600,000 must receive the $600,000 of dividends which they failed to get the preceding year, before the common stock can receive any dividend. In this year, the preferred stockholders would receive the entire $2,200,000 and nothing would remain for the common. No matter to what sum these unpaid dividends on the preferred stock may mount, they must be paid in some form acceptable to the preferred stockholders, before the common stockholder is entitled to receive anything.

The preferred rights of the holder of cumulative, participating, preferred stock do not extend beyond the stipulated preferential rate in the contract, in our example, 7 per cent. Beyond that point, his rights to share in dividends are identical with the rights of the common stockholder. In fact, beyond the stipulated rate of return on his preferred stock, and if his participation with the common stock is unlimited, he is a common stockholder. If participation is limited, he is a common stockholder up to the point where the stipulated percentage of participation has been paid. The participation of the preferred stock with the common stock, in all dividends over the amount of the preferential dividend, is non-cumulative. The right of participation, like the right of non-cumulative preferred stock, expires with the current fiscal year. It can not be carried over to the distributions of future years.

Other Classes of Preferred Stock

Preferred stock may also be grouped into series, according to the order of preference, as first, second, and third preferred, and payment of current and accrued dividends, if any of the issues are cumulative, must be made in the order of preference.

Preferred stock may also be preferred as to assets in dissolution or liquidation by the following provision: "being entitled to receive the par value of their shares and all dividends currently due, or unpaid up to the date of dissolution, before any payment is made to the owners of common stock." This provision guards against the danger in the following situation. A company having outstanding $1,000,000 of cumulative preferred stock, upon which it is in arrears $500,000 in dividends, and

$1,000,000 of common stock, decides to liquidate After satisfying the claims of its creditors, there is available for payment in liquidating dividends to the stockholders, $1,500,000. If the preferred stock is not preferred as to assets, it will first receive the $500,000 of unpaid dividends. The remaining $1,000,000 will then be divided equally between the preferred and common stock, each class receiving $500,000. According to the terms of the above provision wherein the preferred stock is given preference in the event of liquidation, the distribution would be as follows first, $500,000 to the preferred stock representing accumulated dividends, and second, $1,000,000 to the preferred stock representing its par value Since the entire amount—$1,500,000—has been paid to the preferred stock, nothing remains for the common. Where the number of shares of preferred is greater or less than the number of shares of common, and the preference does not extend to assets in liquidation, the amount received by each shareholder is the result of dividing the sum available for liquidation payment by the aggregate of both kinds of shares.

Preferred Stock Sinking Fund

A sinking fund is often provided for the retirement of preferred stock at a premium This fund is usually a percentage of net earnings remaining after the payment of dividends on preferred stock. If a dividend has been paid on the common stock, the amount to be applied to the purchase of preferred stock may be increased. Sinking fund provisions in preferred stock contracts are now common These provisions do not compel the corporation to set aside and pay a certain annual sum to the holders of the preferred stock, instead, the payments are contingent upon profits Assuming, however, that enough profits are earned, the obligation to redeem a portion of the stock is unconditional, unless payment would endanger the solvency of the company.

Protection of Preferred Stock in Asset Account

The preferred stock contract may provide that a certain surplus shall be maintained at all times, and that the net current assets (current assets less current liabilities) shall be kept at a certain ratio to the preferred stock, failing which no dividends shall be paid on common stock The first of these restrictions aims to insure the preferred stockholder against a dividend policy too liberal to the common stock. The second

restriction, as to net current assets, is intended to guard the preferred stockholder against an over-investment of profits in the plant and equipment by which the liquid assets of the company would be so much reduced as to force the directors to borrow too large an amount of working capital This borrowing might result in the creation of claims having priority over the preferred stock Observe that, until this requirement has been met, it is usual to provide that no dividends shall be paid upon any class of stock The operation of this clause will result in the accumulation of dividends on cumulative preferred stock.

Special Voting Powers to Preferred Stock

Special voting powers may be conferred on the preferred stock. For example "The holders of first preferred stock shall elect one-third of the board of directors and shall have in addition full voting rights on all matters by the charter reserved for the determination of the stockholders The remainder of the directors shall be elected by the holders of the second preferred stock and common stock."

Veto Powers of Preferred Stock

It is also usual, for the protection of the preferred stockholder in the security of his income and capital, to impose certain restrictions on the directors in their management of the corporation, thus.

Without the consent, expressed in writing, of three-fourths of the holders of both classes of preferred stock, the corporation shall not (a) create any lien or mortgage upon any of the real or personal property of the company, (b) make any change in the voting powers of any class of stock, (c) sell all or substantially all of the property of the company, (d) sell any part of the real estate or securities of the company without investing the proceeds in new property of a similar character, (e) make any increase in the authorized amount of either class of preferred stock, or create any stock issue having priority over the first preferred stock, (f) authorize the increase of either class of preferred stock, and even with the consent of the holders of three-fourths of each class of preferred stock, authorize any increase in such issue unless the earnings for the preceding fiscal year are   ; also unless all arrearages of dividends on the class of preferred stock that it is proposed to increase shall have first been discharged, (g) issue any bonds or notes maturing more than one year from the date of issue, (h) change the voting power of either class of preferred stock.

The purpose of these restrictions is to secure for the preferred stockholders adequate representation on the board of directors, and to make it possible for them to veto any acts of the corporation which they may consider injurious to their interests, especially the creating of additional issues of preferred stock or bonds, which might dilute their security. The three-fourths percentage is that usually selected A larger proportion would open the door to obstructive blackmailing tactics by a small minority. A bare majority might act unfairly to a large minority. Whatever course of action meets the approval of holders of three-fourths of the preferred stock, will usually be fair. Additional restrictions may limit the compensation of officers to a percentage of gross sales or net earnings, or may give the preferred stockholders a veto on the payment of aggregate salaries above a certain amount It may be provided that the consent of a majority of the preferred stock is required to authorize the pledging of any of the quick assets of the company as security for a loan, or the leasing of its property, or the placing of its endorsement on any notes. This is aimed to guard against practices which have involved many corporations, once prosperous, in serious embarrassment. Claims arising out of the contingent liability of a guarantor come before the preferred stock whose interests are protected by the grant of this right of veto.

Classification of Directors for Benefit of Preferred Stock

For the purpose of securing permanence of control by representatives of preferred stockholders, classification of directors may be provided for as follows.

The directors of the company shall be divided into three classes The directors of the first class, numbering one-third of the total number of directors, shall be elected for a term of five years by the holders of the first preferred stock The directors of the second class, also one-third of the total number, shall be elected for a term of two years by the holders of the second preferred stock The remaining directors for the company, composing the third class, shall be elected for a term of one year by the holders of the common stock.

It is impossible, with this provision in force, to make a sudden change in a company's policy; for example, to embark on a campaign of price-cutting or lavish advertising, or to abandon or establish branch estab-

lishments, or to borrow large sums, by purchasing control of the company and summarily ousting at the next election a board who may not be in sympathy with these ideas. With this classification of directors in force, two elections must be held before the new control can secure a firm domination of the board. Within that time, the new proposals can be thoroughly examined and any weakness disclosed.

Remedies of Preferred Stockholders When Protective Covenants Are Violated

When any of the foregoing covenants are broken, a drastic remedy is provided:

> In case of a breach of any of the foregoing covenants by the corporation, it is agreed with the holders of the preferred stock that at the next election all the votes for directors whose terms then expire shall be cast by the holders of the first preferred stock, and that at the second election next succeeding such breach of covenant and restriction, all the votes for directors whose terms shall then expire shall be cast by the holders of the first preferred stock so that after the second annual election all the directors of the company shall have been chosen by the holders of the first preferred stock. And it is further agreed that the terms of such directors shall be equal to the terms of the directors by the preceding section required to be elected by the holders of the first preferred stock, so that in case any of the foregoing restrictions or covenants shall be violated within one year thereafter, the entire board of directors shall be chosen by the holders of the first preferred stock.
>
> And it is further agreed that the exclusive voting power, not only for directors but on all other matters by law reserved to the stockholders, so long as the above mentioned breach of covenant may continue and for one year thereafter, shall reside and be vested in the said holders of the first preferred stock, and it is further agreed that the report of the auditors of the company as to the observance of the above described covenants and conditions shall be conclusive as to the fact of their breach or observance.

In addition, it is frequently provided that the above remedy shall be available to the preferred stockholders, if the company fails to pay, quarterly or semi-annually, the regular dividends on the preferred stock for two or four consecutive periods. Of all provisions for the protection of preferred stockholders' rights, this is the most valuable. Control of a corporation is a vital matter to those who possess it. Prestige, personal bank credit, salaries, and other emoluments all go with control.

With the foregoing provision inserted in his contract, the preferred stockholder may be reasonably assured that if earnings are available to pay preferred dividends, they will be paid before the arrearages approach the point when control would be lost Other protective provisions are valuable or not, according to circumstances This provision for the forfeiture of voting power, under all conditions, is of the greatest value to the preferred stockholder

Right of Redemption

A provision frequently met with in preferred stock contracts is the right of redemption at a premium. If the company is prosperous and has available funds, it may reserve the right, common also in bonds, to retire its preferred stock, saving the preferred dividend, and also freeing the common stock from the irksome restrictions and privileges which the preferred stockholder demands. The premiums which the company is usually required to pay upon redemption, is to compensate the preferred stockholder for his loss in surrendering a desirable investment

Variations in Nomenclature

A variation of the distinction between preferred and common stock is found in the growing use of A and B stock. An illustration of this stock follows.

> Class A stock is entitled to receive ordinary cumulative dividends of $3 50 per share per annum before any dividends can be paid on Class B stock In any year in which dividends at the rate of $3 50 per share have been paid or provided for Class A stock, then a dividend at the rate of $1 00 per share per annum may be paid on Class B stock Whenever in any year the foregoing dividends have been paid or provided for, then all subsequent dividends declared or paid in such year shall be so declared alike, until Class A stock has received a participating dividend of $1 50 per share, making a total dividend of $5.00 per share for such year, and then all subsequent dividends in such year shall accrue to the Class B stock

Here is a distinction without a difference. Class A stock is cumulative, participating, preferred stock, and Class B stock is common stock. The new characterization is for marketing purposes. Class A sells as well as preferred stock and Class B sells better than common stock. Hence the change in labels.

Objections to Preferred Stock Contract Restrictions

Many objections have been made to this common practice of including in preferred stock contracts restrictions similar to those used for bonds These objections are based on the inconvenience, expense, and sometimes serious interference with the growth of the company which the existence of these restrictions involves A typical instance of an apparently well-founded objection to restrictions in preferred stock covenants is the following statement issued on behalf of the Hood Rubber Company

The provision of the existing preferred stock requiring the retirement in each year of not less than 3 per cent of the par value of all stock of this class then outstanding, and in any event not less than $150,000, has been complied with in each year by the company. This has resulted in a steady contraction of capital to the extent of this requirement of the preferred stock, and to offset this, and to supply additional needed capital, it has been necessary to make successive additional issues of new stock of this same class. Up to and including 1925 the company will have retired preferred stock of this class amounting to $960,000. During the same period in which this retirement has taken place there has been issued additional preferred stock of the same class amounting to $3,850,000 This situation not only has involved the company in very considerable and needless expense, but it has also hampered its healthy and natural expansion

The preferred stock also contains a restriction against the company's issuing notes having maturity longer than one year without the consent of the holders of three-fourths of this stock The effect of this provision is to prevent taking advantage of long time financing in its loans In fact the disadvantage of this provision proved to be so obvious and so serious that the company asked for and received the consent of the holders of more than the necessary three-fourths of this stock in connection with its issue of $6,000,000 15-year debenture notes Because of the large number of scattered stockholders this involved an expenditure of time and money which ought not to be necessary The use of these long time debenture notes is of undoubted value to the company, and doubtless it will be wise from time to time to use this method of financing again, not only in respect of additional working capital, but also for refunding of the existing notes when conditions make refinancing profitable In order to take advantage of such conditions the management should be free to act without the delay incident to consulting so many stockholders

The directors believe that these two provisions are not in accord with the

financing policies of the present time, that they tend seriously to restrict the natural and economical provisions for the steady increase of business, and that in the long run they operate to the distinct disadvantages both of the preferred and common stockholders and that they should be eliminated.[2]

These objections of management to such restrictions are natural. Any active business man is impatient with any law, regulation, or contract provision which interferes with his freedom of action. All such regulations hinder management. It must be admitted, however—especially for the United States, where the standards of business management, both in judgment and in ethics, are not as high as could be wished, and where many reckless financial practices are often condoned, if not justified, by current financial opinion—that it is unsafe to leave preferred stockholders (who, after all, are not protected by any lien on property, whose dividends are optional with directors, but who have paid relatively higher prices for their stock, and have accepted usually a smaller return than common stockholders expect), to the risks involved in the unlimited freedom of action by management.

From the standpoint of management, non-cumulative preferred stock is the ideal form. The argument in support of this statement runs as follows. The stockholders have placed their trust in directors to manage the business according to their best judgment. The directors are responsible to all classes of stockholders. Why should directors be forced, against their better judgment, because of the cumulative provision, to pay out to preferred stockholders earnings which are needed to build up the company? The cumulative provision frequently forces managements, if they think it necessary to prevent accumulation of dividends ahead of common stock, to borrow money for the urgent needs of the company, which borrowing would not be necessary if preferred dividends were not paid. To this objection the answer is that, without the cumulative provision, the preferred stock could not ordinarily be sold, and that the company has obtained money on more favorable terms, without any additional obligation to repay, because it has given the preferred stockholders a cumulative claim on dividends declared. It is the same with the veto power ordinarily given to preferred stockholders on proposed mortgages on the company's property, or on the issue of long-term bonds without mortgage security. This is often a handicap to management which sees an opportunity for the investment

[2] *Commercial and Financial Chronicle*, Volume 122, p. 357.

of money in profitable expansion, which could be obtained by borrowing, and which risks the delay and the expense of securing the consent of the preferred stockholders, in measures which management believes to be wise

Experience shows, however, that the danger of borrowing for expansion often outweighs the advantage of such expansion In view of this danger of debt, the preferred stockholders should have the right, before a debt and mortgage policy is inaugurated, to use what judgment they have in expressing their opinion. If the management can not convince the preferred stockholders that the borrowing policy is wise, it is probably not wise. The delay and expense involved in securing the preferred stockholders' assent, while irksome, not only compels the management to justify its policies to the stockholders, but involves delay and discussion which in most cases is very salutary The late John D Rockefeller was a strong advocate of unanimity in business decisions Although he held a working control in the Standard Oil Company, he never forced his views upon his associate directors In some cases, it is reported that, although himself strongly convinced of the wisdom of the proposed expenditure, if he was not able to secure the unanimous and cheerful consent of his associates, he would lay the matter aside for further consideration

In concluding this discussion of preferred stock, we emphasize a fact which is too often lost sight of Preferred stock is always and everywhere *stock*, a representation of ownership in a company. Its value is only comparative It is better than common stock, but that is all. Compared with a bond, preferred stock is inferior. Its dividends can not be collected by legal process against the decision of the board not to pay them In the face of unpaid debts or unfulfilled provisions to pay debts, the claims of its "accumulated" dividends are valueless

CHAPTER 7

BONDS

Every business corporation has authority "to borrow money for any or all of the purposes for which it is organized, to issue its promissory notes, bonds, or other certificates of indebtedness, for the repayment thereof, with interest, and to secure any of its obligations by mortgage, pledge, or deed of trust of, or on, any of its property, franchises and income."

In this brief section, which is taken from the Corporation Law of Pennsylvania, and which is found with little change in the corporation laws of every state, is described the method by which American corporations have, for over one hundred years, provided funds for the development of their businesses. Reducing the concept of secured borrowing to its lowest terms, it involves two steps first, the execution of promissory notes, by which the corporation agrees to pay a sum of money at a stated time, and interest in the meantime at a stated rate, and second, a contract of security which supplements and strengthens, in the mind of the lender, the willingness and ability of the borrower to discharge his obligation.

These contracts of security are of various forms. First, there is the primary right, which is guaranteed in the Fifth Amendment of the Constitution of the United States, to collect by legal process against the debtor the face of a note, with accrued *simple* interest, in the event of default by the debtor on his obligation. The Fifth Amendment provides that no person may be deprived of life, liberty, or property without due process of law The Supreme Court has repeatedly held that any variation in the terms of a contract by which the amount of creditor's claim is reduced, except in bankruptcy proceedings, is a violation of the Fifth Amendment

In addition, there is a group of contracts for the protection of the creditor, giving him various forms of control over the business of the debtor, to insure that the debtor will keep his property in good order and repair and pay all liens and claims against it which might, in the event of legal proceedings against the debtor, come ahead of the par-

ticular creditor's claims Lastly, there are contracts of endorsement, guaranty and surety, mortgage on real estate, pledges of tangible and intangible personal property, and pledges and assignments of contracts of various forms These security contracts will be considered in later chapters

Nature and Definition of Bonds

A corporation bond is one of a series of long-term promissory notes, usually in denominations of $500 or $1000, although they may be drawn for any denomination up to the full amount of the debt, each note representing a proportionate share of the total debt—$1,000,000, $5,000,000, or $500,000,000, as the case may be The separation of this debt into small "pieces" is for purposes of ready sale

A corporation wishing to borrow $5,000,000, even on the best security, might have difficulty in placing the entire loan with a single investor No matter how good the security, few investors have funds sufficient to take up a loan of this amount By issuing, instead of one note for $1,000,000, 1,000 notes for $1,000 each, the corporation is able to draw upon the money of a large number of investors who may buy up notes in lots of one, five, or fifty

Students of law, have sometimes excluded corporate bonds from the general definition of a promissory note, on the ground that a corporation bond does not contain words of negotiability, as do promissory notes. These words are usually "pay to the order of." The negotiability of a promissory note is something entirely apart from the obligation to pay money. It merely provides for transferring the right to receive the money promised by the note, from the payee to any person to whom the payee may assign it, free from any defenses which, while in the payee's hands, might be set up against an action on the note The effect of negotiability clearly appears when the note is found in the possession of a third person known as an "innocent holder for value," or a "holder in due course" Any one who receives a negotiable instrument in the ordinary course of business, in return for a valuable consideration, even though the instrument may have been stolen, of course without the knowledge of the holder for value, may recover from the maker of the instrument A promissory note need not contain words of negotiability, although it usually does so Such an instrument that says "sixty days after date I promise to pay to John Smith $100, signed William

Jones," is a promissory note, but, because it contains no words of negotiability, it is not a negotiable instrument.

The corporation bond is issued in two forms, either "pay to John Smith, $1,000," signed and sealed by the officers of the corporation and duly authenticated by the trustee, or "pay to bearer $1,000," with the same signatures and authentication. In either case, the instrument is transferable In the second case—the bearer bond—any one may receive it and recover on it if he is an innocent holder for value, in the case of the bond payable to a named individual—the registered bond—transferability may be imparted to the bond by an execution of a blank authority attached to the bond providing for the transfer of the bond to any person who may insert his own name in the blank space provided in the authority

By common usage, the term of a corporation bond must be more than five years Any corporation promissory note of a shorter term is known as a short-term note, or commercial paper. Corporation bonds are issued for varying terms, in some cases running for 100 years or more. The present tendency is to reduce the term, and thirty years is the accepted maximum

Reasons for Use of a Trustee

The division of the debt into a large number of "pieces" necessitates the intervention of a trustee to represent the owners of the bonds in all transactions with the debtor company With a single note of $1,000,000, the creditor can personally collect his interest, any payment in reduction of the principal, and the principal, when due He can personally see to it that any covenants which may be included in any supplementary contract of security, will be faithfully observed by the debtor corporation. He can extend the note when due, if that is mutually desirable. Like any private creditor, he can manage his own business with the debtor in his own way, and on his own responsibility When, however, a debt is held by 1,000 creditors, personal relationships between individual creditors, and the borrowing company are impossible. An agent for all the creditors must be appointed to represent them in carrying out the provisions of the debt and of the contracts of security.

This agent is known as the trustee The trustee of a corporation bond issue performs the following routine duties He authenticates the bonds which, since the necessity of his authenticating signature is stated in the

body of the instrument, are of no value without his signature When provided with funds by the debtor corporation, he pays the interest, and receives and disburses the money contributed by the corporation to reduce the principal amount of the bonds by payment before or at maturity He may also, if authorized by the instrument under which he is appointed, disburse the proceeds of the bonds in accordance with the terms of the indenture The trustee *may*, from time to time, upon reasonable notice to the corporation, inspect the property of the borrowing company and examine its books and accounts and data of every kind, to determine whether the company's covenants with the bondholders are being faithfully performed The trustee also exchanges coupon bonds for registered bonds or vice versa, he replaces mutilated and destroyed bonds, and maintains a registry for those bonds which are made payable to named individuals. These are the duties of the trustee of an issue of plain bonds, that is an issue of bonds without the conveyance to the trustee of property to be held for the further security of the bonds When the bonds are to be secured by the conveyance of property, the trustee's duties are greatly expanded

Debenture Bonds

A debenture bond is a "plain" promise to pay principal and interest. In fact, all bonds, no matter what their terms, are debentures. The distinction is commonly made, however, between debenture bonds, and "secured" bonds, protected by pledge of some form of property which supplements and strengthens the obligation expressed in the bond [1]

The form of a debenture, omitting non-essential supplementary provisions, is as follows

No. 1000 $1000

SUN PIPE LINE COMPANY

3½% Serial Debenture
Due September 1, 1940

Sun Pipe Line Company, a Delaware corporation (hereinafter called the Company), for value received, promises to pay on September 1, 1940, to the bearer, or if the ownership hereof be registered, to the registered owner

[1] The reader will note that in the Sun Pipe Line bond which follows, the company has assigned to the trustee, as security, its interest in a contract of guarantee in which the Sun Oil Company (parent corporation) agrees to pay interest and principal on demand This bond is therefore a guaranteed debenture bond

hereof, on the surrender hereof, the principal sum of One Thousand Dollars ($1000), and to pay interest thereon at the rate of 3½% per annum until payment of said principal sum, such interest to be payable March 1, and September 1 in each year, and, until the maturity hereof, only upon surrender of the appropriate coupons hereto attached

Both the principal and interest hereof shall be paid at the office of Girard Trust Company (hereinafter called the Trustee) in Philadelphia, Pennsylvania, in lawful money of the United States of America, and, if legally permissible, without deduction for, and the Company hereby agrees to pay, any normal federal income tax up to but not exceeding 2% per annum, which the Company or the Trustee under the Indenture hereinafter referred to may be required to pay thereon, or be required or permitted to deduct or retain therefrom, under any present or future law of the United States of America, and any taxes up to but not exceeding $4 00 for each $1,000 principal amount of the Debentures which the Company or the Trustee under said Indenture may be required to pay thereon, or may be required or permitted to deduct or retain therefrom, under any present or future law of the Commonwealth of Pennsylvania, except succession or inheritance taxes

This Debenture is one of an authorized issue of Debentures of the Company, designated as its 3½% Serial Debentures, limited to $4,000,000 in aggregate authorized principal amount, of which $300,000 mature September 1, 1935, $300,000 mature September 1, 1936, $400,000 mature September 1, 1937, $400,000 mature September 1 1938, $300,000 mature September 1, 1939, and $2,300,000 mature September 1, 1940, all issued or to be issued under an Indenture dated September 1, 1934, between the Company and the Trustee, to which Indenture (and all supplements thereto) reference is hereby made for a statement of the powers and duties of the Trustee, and the conditions and limitations thereof.

As more fully provided in said Indenture, the Company has assigned to the Trustee, as security for said Debentures, its interest in a certain agreement dated September 1, 1934, providing *inter alia*, for the payment by Sun Oil Company, a New Jersey corporation, to the Trustee, on demand, of all moneys necessary to meet any installment of principal or interest on said Debentures, or any taxes or other charges incident to said Indenture, if the Company should fail to pay the same, when due

On certain defaults by the Company, as provided in said Indenture, the principal of the Debentures may become payable in advance of the expressed maturity thereof.

As more fully provided in said Indenture, said Debentures are redeemable, at the election of the Company, as a whole at any time or in part on any interest payment date, on 30 days' notice, at the principal amount thereof

plus accrued interest thereon, and plus a premium as follows In respect of Debentures maturing in 1935, said premium shall be 2% of the principal amount thereof, in respect of Debentures maturing in 1936 said premium shall be 3% of the principal amount thereof, in respect of Debentures maturing in 1937 said premium shall be 1½% of the principal amount thereof, and in respect of Debentures maturing in 1938, 1939, or 1940, said premium shall be 1¼% of said principal amount if redeemed on or before August 31, 1935, such premium to be reduced by ¼ of 1% commencing September 1, 1935, with a like additional reduction commencing September 1 of each year thereafter, and on and after September 1, 1939, the same shall be redeemable at the principal amount thereof, without any premium.

As more fully provided in said Indenture, Debentures of any denomination, upon surrender at the office of the Trustee, may be exchanged without cost to the holder, for an equal aggregate principal amount of Debentures of other authorized denominations of the same maturity.

Each holder or registered owner hereof, by the acceptance hereof, waives and releases all present or future rights of action for the payment of the principal or interest hereof, hereunder or under said Indenture or any supplemental indenture, against any incorporator, stockholder, director, or officer of the Company or of Sun Oil Company or of any successor corporation.

The execution by the Trustee (or by its successor in trust under said Indenture) of the Trustee's certificate endorsed hereon is essential to the validity of the Debenture

This Debenture, unless registered, shall pass by delivery As provided in said Indenture, upon presentation at the office of the Trustee in Philadelphia, Pennsylvania, the ownership hereof may be registered on the books of the company, as to principal only, in the name of any person designated by the bearer hereof, if so registered this Debenture may be transferred (but only upon similar presentation by such registered owner in person or by attorney duly authorized in writing) either to a new registered owner or to bearer, the latter restoring its transferability by delivery, any such registration or transfer shall in each case be noted hereon by the registrar of the Company.

In Witness Whereof, the Company has caused this Debenture to be duly executed by its proper officers under its corporate seal, and properly authenticated interest coupons to be hereto annexed.

Dated September 1, 1934.

SUN PIPE LINE COMPANY,
by

(Corporate Seal) (VICE) PRESIDENT

ATTEST

(ASS'T) SECRETARY

(Form of Trustee's Certificate)

The within Debenture is one of the Debentures which are described in the within-mentioned Indenture.

GIRARD TRUST COMPANY, TRUSTEE,

by

VICE PRESIDENT

(Form of coupon to be annexed to Debentures)

On the first day of , 19 , unless the Debenture hereinafter mentioned shall have been duly called for previous redemption and payment duly provided therefor, Sun Pipe Line Company will pay to bearer at the office of Girard Trust Company, in Philadelphia, Pa., upon surrender hereof, Dollars ($) in lawful money of the United States of America, without deduction for certain taxes as specified in said Debentures (including Federal Income Tax up to 2%), being six months interest then due on its 3½% Serial Debenture, No

TREASURER

OBLIGATIONS OF ISSUING COMPANY

The debtor company, in addition to the contract to pay money and the other covenants in the body of the bond, further covenants and agrees

1. To pay the compensation and the expenses of the trustee

2 To reimburse to each holder of debentures the amount of the taxes imposed by the state of Pennsylvania, up to $4 00 on each $1,000 bond

3 To duly execute and deliver all instruments which the trustee may reasonably require to further secure these bonds

4 That it will not extend the time of payment or accumulate and fund the interest due on any of the debentures

5 That it will at all times maintain an office in Philadelphia, where notices or demands in respect to the debentures or coupons may be served.

6 That it will preserve the corporate existence and all franchises of the company and of each of its subsidiaries

7 That in case the property of the company is subjected to the lien of any mortgage, the company agrees that it will either retire all of the debentures then outstanding, both principal and accrued interest, or secure such outstanding debentures equally and ratably with all obligations so to be secured by mortgage

8 The company further agrees that it will not create any additional funded debt, except upon compliance with the following conditions

a The obligations constituting such additional funded debt shall not mature earlier than October 1, 1940

b The net earnings of the company for twelve consecutive calendar months within the fifteen calendar months immediately preceeding the issue of the obligations constituting such additional funded debt, shall have been at least equal to the aggregate of (1) three times the annual interest charges on all funded debt of the company then outstanding, including that then proposed to be created, and (2) the principal amount of debentures maturing within the succeeding twelve months, provided that this clause (2) shall not be applicable in respect of the $2,300,000 of debentures maturing September 1, 1940 (*The indenture describes in detail how earnings shall be calculated.*)

9 In the event of the increase of its funded debt, pursuant to the provisions of this section, the company will not, prior to October 1, 1940, purchase, or otherwise acquire, redeem, discharge or retire any of the obligations constituting such additional funded debt, except that it may at any time refund the same at a lower rate of interest provided the obligations issued for such refunding purposes do not mature prior to October 1, 1940

10 That it will not, so long as any of the debentures are outstanding, sell or otherwise dispose of, or pledge or otherwise encumber any shares of stock held by it and issued by any subsidiary corporation

11. That it will have made an annual audit and report of its books and those of each subsidiary corporation, on a consolidated basis, in accordance with the requirements of the New York Stock Exchange, beginning with the year ending December 31, 1934. The company will furnish to the trustee copies of such audit and report as soon as prepared, and in any case within ninety days after the close of each such calendar year Any audits or statements furnished to the trustee, as above required, shall, at any reasonable time, be open to inspection by any debenture holder

12 The company agrees that it will secure the redemption, on or before the issuance of the debentures herein subscribed, of all of its existing 5% Sinking Fund Gold Debentures then outstanding under Debenture Indenture dated October 1, 1930, and will obtain the cancellation of said indenture on or before October 15, 1934

These covenants give to the holder of the debentures, in the event of default on any part of its obligations, certain supplementary security in addition to the right of action against the company to recover the amount of the principal of these obligations and accrued interest

Significance of Particular Covenants

The company agrees to execute any other covenants which, in the opinion of the trustee, are necessary to further secure the payment of the debentures. An agreement to insure the property of the corporation or the lives, health, or safety of its employees, or not to assume the obligation of a surety or guarantor to an excessive amount, might be construed as examples of such supplementary covenants

The agreement not to fund or accumulate interest is for the protection of the debenture holders, since the company agrees in advance that it will not obtain any additional days of grace by extending the time of payment of any of its obligations, by agreement with a portion of the bondholders.

The agreement to preserve the franchises of the company and of each subsidiary company is vital to the security of the bondholders, since, without these franchises which are rights to occupy public property for private use, it may not be possible for the company to operate.

The provision against incurring additional funded debt is very important for the protection of the holders of these debentures, and because it facilitates their sale, it is usually included If this covenant is faithfully performed, it will be impossible for the Sun Pipe Line Company, the debtor corporation, to place any mortgage upon any of its property or upon any of the property of its subsidiaries without either first retiring these debentures or giving to its debentures, along with any new bonds which may be issued and which may be secured by mortgage on any of the company's property, the same security as the bonds secured by such a mortgage.

The limitation of the fixed charges on additional funded debt to one-third the net earnings of the company for twelve consecutive months out of the last fifteen months, is also designed to protect the holders of the debentures, and to make it easier to sell them.

The indenture also protects the debentures, by the requirement that the company may not dispose of, either by sale, distribution or pledge, any of the stock of its subsidiaries, which might result in impairing the consolidated structure and reducing earnings

These contracts for the protection of debenture bondholders, as already observed, are supplementary to the right of action which bondholders may exercise through their trustee, in case of any failure to pay

interest, sinking fund or principal, when due. The requirement that the corporation observe the provisions of these restrictions, is evidently calculated to preserve the security of the bonds.

The restrictions in the foregoing indenture of the Sun Pipe Line Company are typical. Additional restrictions can, however, be added. The expenditure of the proceeds of the sale of debentures may be stipulated in detail The money from the sale is paid over to the trustee, and released by the trustee only in accordance with the terms of the indenture. This specification may be general, or it may be as specific as the parties desire In order to obtain the money in the hands of the trustee, the company must furnish the trustee with certificates and other evidence, supported, it may be, by affidavit, signed by the officials of the company, setting forth that certain sums have been spent in accordance with the terms of the indenture, and that the company is therefore entitled to reimbursement Such a covenant might provide as follows.

The Company agrees that the Proceeds of the initial $10,000,000 of said debentures shall be used only for additions and improvements to the plant of the company, and for working capital and other corporate purposes, and that the proceeds of the remaining $10,000,000 of said debentures shall be used only for the acquisition of additional property.

The purpose of such a clause is to give reasonable assurance to the debenture bondholders that a substantial portion, if not all, of the proceeds of an issue will be invested in revenue-producing assets.

While the phrase, "and for other corporate purposes," will permit the management to use a portion of the proceeds for refunding operations or for paying floating debt, the purpose of which would be mainly to preserve the corporate financial status, still the presumption is strong that a substantial portion of the initial issue would be expended upon productive assets, and the second $10,000,000 of the issue could be used for no other purpose

These restrictive covenants in the indenture, if carefully drawn, and observed by the borrowing company, furnish a large measure of surety to the purchaser of the bonds, over the original assurance which an examination of the income account and balance sheet gives him Not only is he assured that the borrowing company can pay his interest at the present time, and that its past record shows current assets comparing favorably with the total amount of its debt, including the debt repre-

sented by these debentures, but the above described restrictions aim to provide that this position shall not be impaired by any act of omission or commission of the borrowing company.

It is impossible to fully protect the bondholder against the vicissitudes of business The earnings of the company, from which debenture interest must be paid, may be impaired by a variety of causes, such as strikes, war, tariffs, business depressions, the competition of other products or services, increases in taxation, the stiffening of wages, and safety legislation Many things may befall any company which will reduce its earnings and weaken the position of its bonds. All that the terms of the indenture can provide, is that the company shall not, by violating the rules of sound financial practice, reduce its ability to pay interest and principal of its bonds.

Convertible Debentures

In order to make debenture bonds more attractive, many corporations have adopted the plan of making these bonds convertible into stock at a certain price. These convertible debentures are direct obligations of the issuing company. They carry a fixed rate of interest and are payable at a definite date In addition, the holders of the bonds are given the privilege of converting them into stock, usually common stock, at a specified price, either up to a given date, or after a given date The conversion price is usually fixed at a figure considerably above the market price of the stock when the bonds are issued.

The advantages offered by these bonds to the investor are evident. A company which has a long dividend record is believed to be reasonably certain to pay interest and principal of its junior bonds The stock of the corporation represents the residual claim to the increase in its profits and values If the business of the company is well conducted, the stock may go to a high price. The holder of the convertible bond can then make a profit by exchanging his bonds for stock.

The securities of new publicly owned corporations, if successful, usually go through a period when they are in the hands of speculators —persons who hold them not for income, but to make a profit on their advance in price. At one time, during its early history, over two-thirds of the common stock of the United States Steel Corporation was in brokerage offices, held for the account of speculators This speculative demand is of great importance in sustaining the value of securities A

feature connected with convertible bonds, which makes them attractive to the speculative element always considered in any sale of securities, is the movement of their value as compared with the movement of stock values. Since the convertible debenture is an unconditional obligation of the corporation to pay money, it will be valued as a bond, and there will be a point below which it will not fall The stock of the same company, although it may pay a higher dividend than the rate of interest on the bond, may fall to a much lower price than the bond, since its claim to dividends is contingent not only upon profits, but upon the distribution of profits by directors, and since this contingent claim to dividends is inferior to the unconditional obligation to pay interest On the other hand, when profits and dividends are large, the price of the stock which is entitled to share in these large and increasing payments, may rise to very high figures The convertible bonds, since they are exchangeable for the stock, under these conditions, also rise more rapidly than other junior lien bonds which do not have the conversion privilege.

Up to and beyond the conversion figure, as long as any of the convertible bonds remain outstanding, the price of the bonds and the stock into which the bonds are convertible, will move together When convertibles are issued, it is customary to fix the conversion price of the stock substantially above the market price of the stock. No conversions take place until the price of the stock on the market advances beyond the price which the bondholder would "pay" by converting. The correspondence, however, between the price movements of convertible bonds and stock, is sufficiently close to make these bonds attractive to a large class of investors who are not averse to taking a speculative profit if this can be done with moderate risk.

Convertible Debentures as a Deferred Sale of Stock

Debenture bonds offer to a corporation whose stock is selling so close to par or stated value that it can not count on disposing of any large amount at that figure, and which is not in a position to issue first mortgage bonds, an opportunity to obtain money on favorable terms by combining the investment quality of debentures with the speculative possibilities involved in the conversion privilege From the company's viewpoint, the sale of convertible debentures is merely a deferred sale of the stock for which the convertibles are to be exchanged. This deferred sale of stock is

often made through conversion at a high price, a much higher price than could be obtained by selling the stock direct. For example, suppose that stock can be sold at 90, and that debentures convertible into the stock at 110 can be sold at par. Suppose also, that the price of the stock rises to the conversion price and the bonds are exchanged for the stock The company has secured, say, $1,000,000, and has issued 9,090 shares for the money by interposing between the receipt of the money and the sale or conversion of the stock, a temporary debt To obtain this amount under the assumed conditions by the sale of stock, in the first instance at 90, would require an increase of 11,111 shares in the stock of the company By deferring the sale of stock until a price of 110 is reached, the company has saved its stockholders the co-participation in profits of 2,021 shares of new stock

Let us, in conclusion, call attention to the real reason for the use of the convertible debentures It is essentially a sales device—a means by which a higher price may be obtained for debenture bonds than could be obtained in the absence of the convertible feature If the bonds are converted, and this depends, of course, on an advance in the price of the stock for which they are exchangeable, the effect on the capital structure of the company is precisely that indicated—namely, a deferred sale of stock This consideration is, of course, in the minds of the management at the time the use of the convertible debentures is decided upon. If the primary object of issuing convertible bonds is to obtain capital by a deferred sale of stock, the conversion prices would be fixed at much lower figures than those usually selected, because in few instances do the market prices advance so far as to make conversion profitable.

Bonds with Subscription Warrants

A variation of the convertible bond is the issue of bonds with subscription warrants entitling the owner of the bond to buy stock in the issuing company at prices which are supposed to be attractive These warrants are either detachable from the bond certificates or non-detachable In the first case, they can be sold just as any other security is sold. Whenever the market price of the stock goes above the subscription price named in the warrant, these rights have a value which rises and falls as the margin between market price and subscription price changes. When the warrant is non-detachable, the right of subscription to stock at a lower price, which the warrant represents, carries up the price of the

bond, if the stock rises above the point at which it is profitable to exercise the warrants. In either event, the bond (or preferred stock) is more attractive and more easily sold because of these privileges, the value of the inducement depending on the buyer's opinion of the future of the stock The use of stock purchase warrants is now general in the sale of bonds and preferred stock. In some cases, moreover, large sums have been raised by the sale of warrants to buy stock at figures far above the market price of the stock when the warrants were sold. They are also used to compensate bankers for guaranteeing the sale of securities of the company which issues the warrants, when there is a good prospect that the stock will rise above the warrant price.

CHAPTER 8

THE CORPORATE MORTGAGE AND DEED OF TRUST

From the beginning of the recorded history of economic institutions and practices, we find the raising of money by the pledge of land When the nomads of Asia first settled down into a fixed habitation and began to cultivate the soil, land was the original form of fixed capital Private property in land emerged with settled habitation and perennial cultivation. Borrowing, an institution which is found in every stage of culture, was soon connected with the possession of land.

The Deed and Mortgage Compared

The mortgage in its earliest form, from which its later forms have not greatly diverged, is a conveyance of real property to a creditor, either to secure the payment of a debt or for the performance of some other obligation The forms of the mortgage, and of the deed by which title to real property is conveyed from one owner to another, are almost identical In each case there is a detailed description of the property, giving its metes and bounds, with sufficient particularity to identify the property conveyed or pledged Connected with this description, in fact preceding it, is the granting clause, by which the grantor, in language which has come down to us from the Middle Ages, grants, bargains, sells, etc , unto the grantee, who is the purchaser, an estate in real property In the case of the deed, the estate conveyed is a fee simple estate, which in the absence of some prior claim gives a perfect title, subject only to the claims of the public authorities for taxes By the mortgage, the owner of the property grants, bargains, conveys, etc., a given piece of property, which is carefully described, to a named person or his representative, "to have and to hold the described property, his heirs and assigns, to the proper use, benefit and behoof of the said party of the second part, his heirs and assigns forever " At this point emerges the difference between the title conveyed by the mortgage and that conveyed by the deed. Up to this point their wording is the same. In the

mortgage, however, appears a clause known as the *defeasance* clause. In the individual mortgage this clause reads as follows

> Provided always, nevertheless, that if the said mortgagor, his heirs and assigns, do and shall well and truly pay or cause to be paid unto the said mortgagee, his heirs and assigns, the aforesaid debt, or principal sum of $3,000, on the day and time hereinbefore mentioned and appointed for the payment of the sum, together with interest as aforesaid, and shall produce to the said mortgagee, etc , on or before the first day of September of each and every year, receipts for all taxes, water rents of the current year assessed upon the mortgaged premises, and shall maintain fire insurance up to an agreed upon amount upon the premises, keep the premises in repair, that then, and from thenceforth, as well this present indenture, and the estate hereby granted, as the said recited obligations shall cease, determine and become void, anything hereinbefore contained to the contrary thereof, in any wise notwithstanding

Purpose of the Mortgage

The purpose and effect of a mortgage is to set aside certain described property for the protection of the creditor, and to provide a method by which the creditor, in case certain agreements and covenants named in the mortgage are not performed by the debtor, may have this property sold, and out of the proceeds, obtain payment of the debt, plus all costs and charges arising out of the collection procedure.

The debtor says to his creditor, in effect "I owe you a certain sum of money This debt is evidenced by a bond. In case I do not pay this bond when due, with interest, on the date stated, you can, of course, sue on the bond, obtain judgment, issue execution and sell any of my property which the Sheriff can find, to satisfy my obligation But in addition, to further assure you that I will pay the obligation and perform the covenants, I hereby deed you certain property described in the instrument of conveyance, and by this deed I convey to you title to the property, which title will remain in you or your heirs and assigns, as long as any part of the debt evidenced by the bond remains unpaid. If, however, I faithfully perform the covenants, set out in this conveyance or mortgage, the title conveyed to you terminates, and you no longer have any interest in the property If, however, I fail to perform any of these covenants, then you may proceed in the manner established by law and have the property sold by the Sheriff, apply the proceeds to the payment of

my indebtedness to you, and sue me for any balance remaining, and obtain a deficiency judgment"

This simple form of security is the foundation of all the secured mortgage debt structures in the United States Every corporate mortgage and deed of trust, some of them containing a hundred or more pages, is an elaboration of this simple instrument which, in one form or another, as already stated, goes back to the beginnings of borrowing and lending.

Classes of Mortgage Covenants

It will be observed that there are two classes of covenants in a simple real estate mortgage. The first relates to the payments of money by the debtor to the creditor. These payments include interest, usually semiannual, payments in reduction of the principal of the bond secured by the mortgage, and a final payment of any balance remaining on the principal The second group of covenants relates to the preservation of the property conveyed under the mortgage to secure the debt In the simple real estate mortgage, this second class of covenants consists, first, of the agreement to pay all taxes. If the taxes are not paid, in many states, although not in all, the authority imposing the taxes obtains a claim upon the property superior to that of the mortgagee, or the holder of the mortgage. The obligation to pay real estate taxes usually extends to the payment of any special assessment for the improvement of the property—for example, for the paving of a street or the construction of a sewer.

Another covenant for the preservation of the property is the fire insurance covenant. Fire insurance policies are made out to the mortgagee, and losses arising under the policy, up to the amount of his loan, are paid to him unless he consents to payment to the mortgagor

A third preservation covenant is to keep the property in repair. This, of course, is for the protection of the mortgagee. If the debtor who is in possession of the property, allows it to deteriorate because he does not paint, paper, and replace glass and shingles, the creditor—the mortgagee—when he exercises his rights under the mortgage, may find that the property will not bring the amount of the mortgage if sold to any one else The creditor in order to "ready" the property for sale may be obliged to pay a substantial sum for repairs

A final step in individual real estate mortgage practice, is the recording of the instrument by copying it in books or by photographic records

kept in the office of the Recorder of Deeds of the county in which the property is located When this record has been made, it is impossible for any other creditor of the mortgagor to establish a claim to the property superior to the claim of the mortgagee The record on the books of the Recorder of Deeds is notice to all the world that this property has been "encumbered" by the mortgage given to secure the bond. Any rights arising under another conveyance or further mortgage encumbrance upon the property, are subject to the rights of the mortgagee, established by the recorded instrument The mortgagor can not sell or pledge the property, except subject to the lien of the mortgage, which is indissolubly attached to the title to the property by the recorded instrument, and "runs with the land," no matter how many times the property may change hands, until the debt is paid

Corporate Mortgage and Deed of Trust

The corporate mortgage or deed of trust, follows closely, although on a greater scale and in more detail, the outline of the simple individual real estate mortgage. The differences between the individual mortgage and the corporation mortgage on real property, arise out of the fact that the individual mortgage is ordinarily a relation between two persons—the borrower and the lender—who deal directly with each other, while the corporate mortgage and deed of trust establishes relationships through an intermediary or trustee, between a corporation—a legal person which can act only in accordance with the terms of its charter and the laws of the state which created it—and a large number of lenders who have advanced money to the corporation For these bondholders, the trustee holds, as their security, legal title to the real property of the corporation The interposition of the trustee, and the fact that the mortgagor is a complex business organization, result in a greater variety of covenants to clarify the relationships existing between the borrower, the trustee, and the lenders, and for the complete protection of the latter

The important provisions of the corporate mortgage and deed of trust are as follows

1. *Parties, Recitals and Forms* Here is given an enumeration of the parties, a recital of the nature of the business of the company and its legal power to borrow money and mortgage the property, a recital of the fact that the bonds have been duly authorized, a description of the

bonds as to form and terms, a certificate to be signed by the trustee authenticating the bonds, and the authorization of the execution of the mortgage by the directors and stockholders of the company

2 *Granting and Pledging Clauses* Next appears the granting and pledging clause, of which the following is typical

> Now, therefore, this indenture witnesseth, that in order to secure the payment of the principal amount and interest on all bonds issued under this indenture according to their tenor and effect, and the terms of this indenture, and the performance of the covenants and obligations herein contained, and in consideration of the acceptance by the trustee of the trust hereby created, of the purchase and acceptance of such bonds by the holders thereof, and of One Dollar ($1) in hand paid by the Trustee to the Company upon the execution and delivery of this Indenture, the receipt whereof is hereby acknowledged, the Company has granted, bargained, sold, released, conveyed, assigned, transferred, pledged, set over and confirmed, and by these presents does grant, bargain, sell, release, convey, assign, transfer, pledge, set over and confirm unto the Union Trust Company of Pittsburgh, as Trustee, and to its successors in said trust, subject to the terms of this Indenture, all the following described properties

By comparing the language used in the individual mortgage with the foregoing, it is evident that the two instruments are the same The first secured the payment of $3,000. The second secured the payment of $100,000,000 The first ran between the individual mortgagor and the mortgagee, the second ran between the Duquesne Light Company and several thousand holders of its obligations, through the instrumentality of the Union Trust Company of Pittsburgh as Trustee The first conveyed, as security for a debt, to a mortgagee, title to a small dwelling house, the second conveyed, as security for a debt, to the Union Trust Company, title to a very large public utility property, which requires 36 pages of closely printed matter to describe, and which includes 189 separate tracts in Pittsburgh and surrounding territory. The company conveys, not merely land and buildings but also all machinery, engines, boilers, dynamos, regulators, meters, transformers, etc, and also, not only machinery which may be now in possession of the company, but which it may hereafter acquire, and also all franchises, privileges, easements and other forms of intangible assets which the company possesses. This mortgage further conveys title to the stocks of certain subsidiary companies now owned, and furthermore provides for the conveying of

title to real and personal property hereafter to be acquired by the corporation

3 *Habendum Clause.* Immediately following this voluminous description of property appears the Habendum clause, which reads as follows

> To have and to hold all the mortgaged and pledged property hereby mortgaged, assigned and pledged, or intended to be mortgaged, assigned and pledged, unto the trustee, its successors and assigns, forever
>
> But in trust, nevertheless, for the equal and proportionate benefit and security of all present and future holders of the bonds and claims for interest and interest coupons, in respect thereof issued, and to be issued, under and secured by this indenture

The Habendum clause specifically shows that the trustee is the custodian of whatever title has been conveyed by the mortgagor for the security of the various bondholders

4 *Definitions.* The next article contains a long list of definitions, the purpose of which is to clarify, in the event of litigation, the understanding between the parties of the various terms employed For example

> Accountant—any accountant or firm of accountants selected by the company and approved by the trustee, including any accountant or firm of accountants employed or retained by the company, when so approved by the trustee

Thus, wherever in this Deed of Trust the corporation has obliged itself to furnish certain information, either to the trustee or to other parties, based upon the statement of an accountant, the above clause will indicate that if the corporation selected the accountant with the approval of the trustee, his competence can not be questioned.

5 *Form, Execution, Registration and Exchange of Bonds.* The next section of the mortgage deed of trust covers the form, execution, registration, and exchange of bonds This section first specifies the amount of bonds which may be authenticated and delivered thereunder In this particular case $55,000,000 of Series A bonds were authorized It further specifies by whom the bonds must be signed in order to be authentic and gives information regarding the validity of any signature In addition, information is given as to the method of registering any bonds issued, and the proper method for exchanging coupon bonds for regis-

tered bonds. This section of the mortgage also provides that the company, the trustee, and any paying agents, may treat the bearer of an unregistered coupon bond or of a coupon as the owner thereof, and the registered holder of a registered bond as the owner thereof. Finally, a portion of this section provides the means for obtaining the replacement of any mutilated or destroyed bonds or coupons.

6. *Terms of Bonds.* The next section of the corporate mortgage sets forth the terms of the bonds to be issued secured by the mortgage. These terms cover such matters as the date of issue and of maturity, the rate of interest to be paid, where the interest will be paid, the premiums which the company will pay on various dates in the event that any of the bonds are called for redemption, the location of the offices of any agencies of the company in addition to that of the trustee, and the method of giving notice of redemption.

7. *The Issuance of Bonds.* This section deals with the issuance of bonds and withdrawal of cash deposited therefor. It is drawn to provide for the initial issue of bonds, the issuance of bonds upon the basis of additional property, upon deposit of cash with the trustee, upon the retirement of refundable bonds, and upon retirement of bonds of another series. The initial issue of bonds is a simple operation, the trustee usually being authorized to certify these bonds upon the written order of the company. However, when the object of the issue is the acquisition of additional property, the authentication and delivery of the bonds is subject in every case to restrictions and conditions set forth in the mortgage deed of trust. It is the custom to provide that the corporation must deliver to the trustee certain written instruments in addition to the written application and order. These instruments are as follows:

a. The resolution of the Board of Directors of the company authorizing the issue of the bonds.

b. The certificate of the company of recent date setting forth, in substance, that additional property is being pledged, stating the cost and fair value of this property and whether any of the property is at the time subject to prior lien.

c. An earnings certificate, setting forth the amount of net earnings of the company, usually for a period of

twelve consecutive calendar months within the fifteen months immediately preceding

d The aggregate annual amount of interest charges on bonds, including those applied for, and that the amount of net earnings are a fixed number of times the aggregate amount of the interest charges on the bonded debt of the company.

e The mortgages, deeds, conveyances, assignments, transfers and instruments of further assurance, and the certificate or certificates and other evidence, if any, specified in the opinion of counsel.

f. Opinion of counsel, stating that the instruments delivered to the trustee conform to the requirements of the agreement

g An independent engineer's certificate, usually stating the fair value of the property, and that, in the opinion of the engineer, its acquisition is advantageous to the company.

The purpose of these provisions is two-fold

1. To prevent the over-issuance of bonds—that is, to make it unlikely that the corporation shall be held responsible for the payment of an amount of debt in excess of that authorized by the mortgage deed of trust

2 To maintain an adequate margin between the value of the property pledged as security for the bonds and the total par value of the bonds outstanding.

8 *Covenants of the Company* Every corporate mortgage contains a list of obligations which the corporation assumes in the event bonds are issued. These cover such matters as

a The payment of interest and principal.

b Assurance that the company will preserve good title to the mortgaged and pledged property, and with this object in view to pay the taxes as they accrue.

c. Maintenance of an office for transfer and registration of bonds

d. That the business will be conducted in a proper manner, that books will be properly kept and financial statements furnished

e Provision of adequate insurance covering all of the property which has been pledged.

9 *Maintenance and Renewal Fund* This section of the mortgage sets forth the promise of the corporation to keep its property adequately repaired.

This provision is extremely important from the viewpoint of the corporation, its stockholders, and its creditors, and in many mortgage deeds of trust created prior to 1918, attempts were made to pin the corporation down to a specific percentage of gross earnings which it agreed to spend on the maintenance and renewal of its property. For example, the following provisions are found in the mortgage given by the Texas Electric Railway Company to the Harris Trust and Savings Bank, Trustee, dated January 1, 1917

1 The company will establish a special Trust Fund to provide maintenance

2 The company will furnish the Trustee with an annual statement showing

a aggregate gross earnings,
b total maintenance and renewal expenditures,
c expenditures for additions and extensions paid for in cash and for which no bonds have been issued,
d unexpended cash balances remaining in Trust Fund

3 The company will deposit in cash in the Trust Fund the following amounts, the amount by which

Eleven per cent of the gross earnings for 1917,
Twelve per cent of the gross earnings for 1918,
Thirteen per cent of the gross earnings for 1919,
Fourteen per cent of the gross earnings for 1920,
Fifteen per cent of the gross earnings from 1921 to 1945 inclusive, exceeds the amount expended under Section 2 (*b* plus *c*)

4 The Trust Fund may not be drawn against by the company unless they have made replacements, renewals, extensions, etc , and delivered to the Trustee a sworn statement that they have done so, and if no bonds have been issued to pay for such replacements, etc

Informed financial opinion has, in recent years, largely abandoned these provisions The form now used is the general agreement to maintain the property in good condition and repair Experience shows that the requirement that a specific percentage of gross earnings should each year be expended upon the property, when gross earnings sharply declined, caused embarrassment. At such a time, if the company was well-managed and had ample cash resources, the percentage requirement was meaningless, since it was not sufficient when applied to a diminished gross sum, and the company made up the difference. On the other hand, to enforce the requirement, when gross earnings have seriously declined and when maintenance expenses may be curtailed for a time without extensive damage, in order to provide funds for interest payment, might put the company into bankruptcy, which is the last thing which the bondholders wish. A provision which has no practical value should not be included

10 *Possession, Use and Release of Mortgaged Property* When a corporation borrows and secures the debt by conveyance of title to all of its property, it is essential that it agree either to retain all of the property, or to provide that the proceeds of sale or exchange of any property which it is profitable or necessary to sell should be invested in new property, which new property should be subject to the lien of the mortgage This matter of the release of property from the lien of the mortgage involves the corporation and the trustee, since the trustee is the legal owner of all of the property, and without a formal release, the company can not give good title to any of the property which it wishes to sell.

The consent of the trustee to the sale is required, except when the property to be disposed of is of specific kinds (items which wear out rapidly and are constantly replaced), in which event provision is made for waiving this requirement When such a waiver is provided for, the property which may be disposed of at one time and/or within a definite period of time, is limited in value, or the company agrees to substitute other property of at least equal value. The consent of the trustee to the sale or exchange of property by the company is evidenced by the release thereof from the lien of the mortgage or trust indenture.

The bonds of the Duquesne Light Company, secured by a lien on numerous properties, including real estate, power houses, sub-stations, poles, and a variety of other property which stands on the books of the company at $171,592,250, are forty-year bonds, the First Series matur-

ing in 1967. During this long period, the art of producing, distributing and utilizing electric power, will be modified, the progress of invention will bring into use many new machines, appliances, and devices which will make the existing plant obsolete Many parcels of real estate placed under the lien of the mortgage will eventually become useless to the company because of a shift in the location of the population in the territory, or for some other cause The entire property of the company may change during the life of the bonds In this process of change, it will be necessary for the properties, and the buildings and machinery erected on them, to be sold or exchanged for other property in order to keep the plant of the company up to date. Consequently, the corporation would be at a disadvantage if it were not permitted to sell any part of the pledged property It is therefore in the interest, not only of the corporation, but of the bondholders, that property no longer needed for the company's operations should be disposed of on the best possible terms, and with the smallest amount of interference The only stipulation which it is necessary to make for the protection of the bondholders in such cases is first, that when any part of the property is sold, it should be sold for an adequate price; second, that the proceeds of sale or exchange, in case the property is exchanged, should be invested in other property and that the title to this other property should be conveyed to the trustee, and third, that in case it is not considered desirable to invest these proceeds in other property, they should be applied to redeem the bonds which the property sold originally secured.

The method of releasing property from the lien of an indenture is covered by certain provisions in the Mortgage Deed of Trust The consent of the trustee to the sale or exchange of the property by the company may be given when the company provides the trustee with a resolution of the board of directors, requesting the release, describing the property, and a certificate of the company. The certificate of the company usually sets forth that it has sold or exchanged, or has contracted to do so, the property to be released, that the sale or exchange is desirable in the conduct of the business of the company, that the property to be released is no longer useful in the business of the company, and that the consideration received has a value to the company at least equal to that of the released property

11. *Defeasance Clause* If all of these covenants so carefully enumerated in the mortgage are complied with, as it is expected they will be

complied with, by all parties to the agreement, and at the end of the term mentioned in the bond these bonds are paid, either in cash or by the issue of other bonds under another mortgage, then the entire affair is to be wound up according to the terms of the instrument. These terms are set forth in the defeasance clause, which corresponds very closely to the same clause in the individual real estate mortgage already referred to. The defeasance clause in the Duquesne Light Company Indenture is as follows

> When all of the bonds and coupons hereby secured shall have been paid or redeemed or the Company shall have provided for such payment or redemption by depositing in cash with the Trustee the entire amount necessary for such payment or redemption, and shall also have paid, or caused to be paid, all sums accrued and payable hereunder by the Company and the Company shall have advised the Trustee in writing that it intends to issue no further bonds under this Indenture and Indentures supplemental thereto, then and in that case, this Indenture shall cease to be of effect and shall become void, and all the mortgaged and pledged property shall revert to the Company, and the estate, rights, title and interest of the Trustee in respect thereof shall thereupon cease, determine and become void

In the preceding paragraphs, we have outlined the normal course of procedure when a corporation borrows and gives a mortgage upon its property. This procedure starts with the execution of a mortgage by which the legal title to the property pledged is conveyed to the trustee The trustee holds this property during the life of the bonds which the mortgage secures The company performs the numerous covenants contained in the mortgage—it pays interest and principal, it keeps the property in repair, it performs the obligations of all franchises pledged, it pays its fire insurance premiums and the indemnity payments under these policies are invested either in new property or applied to the redemption of the bonds which the mortgage secures From time to time, it obtains releases of property no longer needed for the purposes of the business, and the proceeds of the sale or exchange of this property are applied either to the purchase or construction of new property or to the redemption of the bonds At the end of the time named in the bonds and the mortgage, they have either been paid off by the operation of the sinking fund, or arrangements have been made to replace them with another issue of bonds, giving the holders of the old issue the privilege

of accepting cash, or taking the new bonds in exchange for the old bonds. The matter is now concluded by the delivery to the company of a release and satisfaction by the trustee of all right, title and interest which the trustee, under the indenture, has in the pledged property.

This is the normal course of affairs This is what is expected by those who enter into these mortgage covenants, and in most cases these expectations are realized

12 *Remedies Upon Default.* Provisions must be made, however, for the protection of the bondholders in case these covenants are not carried out by the borrowing corporation A breach of any one of the covenants constitutes what is known as an Event of Default, and the mortgage therefore contains an extensive section entitled Remedies upon Default. The usual events of default are enumerated as follows

> 1. Failure of the company in the punctual payment of the principal of any of the bonds
>
> 2. Failure of the company in the payment of any instalment of interest on any of the bonds and such failure continuing for days [1]
>
> 3 Failure of the company in the payment of any sum payable for the sinking fund created by the agreement and such failure continuing for days [1]
>
> 4. If an order shall have been made for the appointment of a receiver of the company, or of its property, and remain in force for days, or the company shall be judicially declared to be bankrupt or insolvent
>
> 5 If the company shall institute proceedings for voluntary bankruptcy, or shall apply for, or consent to, the appointment of a receiver for itself or its property, or shall make an assignment for the benefit of its creditors, or shall admit in writing its inability to pay its debts generally as they become due
>
> 6. Failure on the part of the company in the due performance of any of the covenants, conditions, or agreements on its part, in the bonds, or in the mortgage deed of trust or indenture contained, and any such last named default shall continue for days, after written notice thereof shall have been given to the company by the trustee (whose duty

[1] It is the practice to permit the corporation a period of grace extending for 30, 60, or 90 days, within which to correct the condition responsible for its default.

it shall be to give such notice at the request, in writing, of the holders of at least [2]) per cent in principal amount of the bonds at the time outstanding)

Should any of these Events of Default occur, and remain in effect beyond the period of grace usually named in the mortgage, certain remedies are available to the trustee and the bondholders It will be recalled that in the discussion of the individual real estate mortgage, the mortgagee was given the right to apply to the court for a writ instructing the Sheriff to sell the property in order to satisfy the mortgagees' bond The corporate mortgage follows, in principle, the same procedure in the event of default. The mortgage states specifically that the trustee upon default may do any of the following

1 Enter upon and take possession of the mortgaged and pledged property, or any part thereof, collect and receive all rents, income and profits therefrom, and operate and conduct the business of the company to the same extent and in the same manner as the company might lawfully do, or

2 By such officer or agent as it may appoint, it may, with or without entry, sell all the mortgaged and pledged property as an entirety, or any such parcel as the holders of a majority in interest of the bonds secured thereby and then outstanding shall in writing request, or, in the absence of such request, as the trustee may determine at public auction

3. May cause this indenture to be foreclosed and the mortgaged and pledged property . . . to be sold

4 May proceed to protect and enforce the rights of the trustee and the bondholders hereunder . .

5. Shall be entitled as of right, without notice, to the appointment of a receiver of the mortgaged and pledged property or any part thereof

13. *Concerning the Trustee.* We have shown that the individual bondholder has no connection with the company. All of these elaborate provisions in the contracts of supplementary security, which have been enumerated and described, are not enforced by the bondholder, but by the trustee, if, in fact, they are enforced at all. The trustee stands *in*

[2] The number of bondholders who are required to request, in writing, action on the part of the trustee, varies from 10 per cent to a majority in principal amount outstanding

loco parentis to the bondholder. He is the fiduciary. He holds the property in trust for the protection of the bondholders' interest Whatever can be done to protect that interest, the trustee must do. Bondholders attach much importance to the trustee, and investment bankers are careful to secure as trustees for bond issues which they sponsor such trust companies as the Central Hanover Bank and Trust, the Guaranty Trust, the Bankers Trust, or the Continental Bank and Trust Company of Chicago The names of such large and strong institutions on the corporate mortgage and deed of trust, inspire confidence in the bondholders, and assist in the sale of the bonds. The bondholder is impressed by the character, the reputation, and the resources of this great financial institution which, in his opinion, stands sponsor for the bonds and undertakes to protect his interests.

As a matter of fact, however, this so-called protection is misunderstood by many bondholders The trustee, in accepting the trust under the mortgage, stipulates first his adequate compensation This direct compensation is very small The standard schedule of fees for administering a corporate mortgage and deed of trust of $10,000,000 in New York—prior to 1940, when the Trust Indenture Act of 1939 became effective and forced an increase in trustees' fees—including acceptance of the trust, registration and conversion of the bonds, disbursement of the proceeds of the bonds when that is provided in the indenture, authentication of the bonds, payment of the interest and principal, administration of the sinking fund when this is provided, release of property from the lien of the mortgage, and notification of the bondholders in case of default—was $1,100 a year. In addition, the trustee has the use of large sums of money for short periods in preparation for the payment of coupons, the redemption of bonds out of the sinking fund, or the payment of principal, when due. This compensation was not large It did not compare with the fees which the corporation paid to its attorneys, regular or special It was one of the smallest items of corporation disbursement. The only way in which the trustee could make any profit out of this function was to combine a large number of corporate trusts in its corporate trust department and handle this business by a moderately paid clerical staff.

14. *Exculpatory Clauses.* In addition to these measurable profits, there is, of course, the intangible value of the prestige attached to the office of trustee of a mortgage of the Pennsylvania Railroad Company

or of the New York Central. This prestige value is not measurable, but is considerable A corporate trusteeship undoubtedly attracts deposits and other profitable business Such trusteeships are eagerly sought for and greatly valued. On the other hand, the trustee has large resources, expressed in its capital and surplus, and it has no idea of endangering these resources by any suits which might be brought by disgruntled bondholders for its failure to perform any of the obligations of the trust To save itself from such liability, as a universal practice, the trustee accepted the trust only on the basis of complete exculpation, that is, immunity from all liability except its own wilful negligence.

For example, in the mortgage of the Duquesne Light Company, Article 11, concerning the trustee, appear the following clauses, somewhat abbreviated

> 1 The trustee shall not be responsible for any recitals or for insuring the mortgaged property, or for collecting any insurance money, or for the execution and recording of the indentures, or for the sufficiency of the security of the bond, or for the value or title of any of the pledged property, or for the payment of any taxes upon same, and further that the trustee is not required to inquire as to the performance of any covenants by the company. The recitals and statements in this indenture and in said bonds and coupons contained, shall be taken as statements by the company, and shall not be considered as made by or as imposing any obligation or liability upon the trustee.
>
> 2 In its communications with the company, the trustee shall be protected in acting upon any notice, request, consent, certificate, order, affidavit, letter, telegram, or other paper or document believed by it to be genuine and correct, and to have been signed or sent by the proper person or persons
>
> 3. The trustee shall not be compelled to do anything toward the enforcement of the trust created by the mortgage, or to defend any suit unless indemnified to its satisfaction against loss, cost, liability and expense
>
> 4 As to any fact upon which action may be required by the trustee, except as otherwise expressed or provided, it is entitled to rely upon a certificate of the company, signed by its officers, as sufficient evidence of the fact, and it is not required

to go beyond the certificate to ascertain whether these officers are deliberately misrepresenting these facts

5 The trustee shall not be liable for any action taken by it in good faith and believed by it to be within the discretion or power conferred upon it by this indenture or be responsible for the consequences of any oversight or error of judgment, and the trustee shall be answerable only for its own acts, receipts, neglect, and default, and not for those of others, nor for those of any person employed and selected by it with reasonable care, nor for any loss unless the same shall have happened through its own wilful default.[8]

6. The trustee shall not be required to take notice of any default unless specifically notified in writing by the holders of at least 10 per cent of the bonds then outstanding

The provisions concerning the trustee were summed up in a lecture delivered before the Association of the Bar of the City of New York by Francis Lynde Stetson, as follows

Theoretically the trustee of a corporate mortgage ought to have an active supervision of the trust, but practically the liabilities which in such case it would assume would be altogether out of proportion to the compensation which mortgagors are able or willing to pay. In fact, the compensation paid to trustees for services prior to defaults are merely a reasonable sum to cover the value of supervision and clerical work in connection with the issue of bonds

Accordingly, the responsible trust companies in New York require provisions granting them immunities from the strict duties of a trustee They assume no responsibility for acts of agents selected with reasonable care, or for anything except wilful misconduct or gross negligence They assume no duty to see to the use of bonds delivered pursuant to the provisions of the indenture nor for the validity of the bonds nor the value of the security. They are not to be bound to take any action toward the enforcement of the trust unless notified of default by bondholders and furnished with satisfactory indemnity against expense, nor required to take any action unless specifically requested so to do by a specified percentage of the bondholders, usually 10 per cent to 25 per cent. They are to be protected in acting upon any instrument believed by them to be genuine, and are entitled to advice of counsel at the expense of the mortgagor

[8] Since the trustee always acts through employees, it is, in effect, liable for nothing except for corporate action taken by its board of trustees to deliberately violate some provision of the mortgage

The effect of the "exculpation" of the trustee in the corporate mortgage and deed of trust from all liabilities connected with its administration, is not generally understood by small investors In fact, it makes the work of the trustee merely a routine, mechanical function which does not involve the exercise of independent judgment Whatever protection the bondholder has, is contained in the terms of the mortgage If the officers of the company live up to the provisions of the mortgage, that protection is effective. If they violate them—and some of them have, in some cases, been grossly violated—the bondholder can not look to the trustee to protect him from the consequences of such breach of trust, not made by the trustee, but by the officers and directors of the company [4]

The term trustee is a misnomer as applied to the corporate trustee It is merely an administrative agency whose functions were purely mechanical

The Trust Indenture Act of 1939

The Securities Exchange Act of 1934 provided in Section 211 that the Securities Exchange Commission should investigate the practice of corporate trustees and analyze trust indentures with the public interest in mind Their investigation disclosed a number of faults adverse to the public interest In some instances no trustee was provided for, so that individual action against the corporation was costly and concerted action by bondholders was difficult, due to their dispersion and the effort required to obtain their names and addresses. Many trustees did not have adequate rights and powers to protect the investor, since the trustee was under no obligation to act upon default unless he was notified of the default, ordered to act, and indemnified by a substantial percentage of the bondholders. Thus he was relieved from liability for negligent action or failure to act Many trustees lacked resources commensurate with their responsibilities, were related to the issuers or underwriters of the bonds, or held interests in the issuers or underwriters which might materially conflict with the interests of the investors. Indentures frequently failed to require the corporations to furnish adequate current

[4] Maintenance provisions of corporate mortgages have often been violated There is no case on record where the trustee has voluntarily declared a default for these reasons Nor do bondholders demand that he do so They are well satisfied to obtain their interest, even at the expense of the condition of the property If they think about the matter they expect the cost of neglecting the property to be paid by the stockholders See post chapter 25, pp 330 to 338

financial information to the trustee, or to certify to performance of obligations under the indenture. Frequently, the corporation was not required to furnish the trustee with the names and addresses of bondholders, so that he did not know for whom he acted as trustee Many indentures contained deceptive provisions Corporations failed to advise investors as to the effect of important provisions Since trust indentures are usually prepared by the corporation or the underwriter before the bonds are offered for sale, the investor can not join in their preparation and is unable to procure correction of the defects

Following the commission's investigation and recommendations, Congress passed the Trust Indenture Act in the summer of 1939, to become effective on February 1, 1940 The Act assumes that defects in in corporate trust practice were due to deficiencies in trust indentures, and attempts to correct them before securities are sold to the public. It applies only to indentures covering bonds publicly offered by means of the instruments of interstate commerce Thus all indentures required to be filed with the Commission under the Securities Act of 1933 must conform, and registration of such securities shall not become effective unless the indenture does conform

The basic purposes of the act are (1) to provide complete and accurate disclosure of the essential provisions of trust indentures when securities are first issued and so long as they are outstanding, (2) to provide means for giving investors continuing disclosure of all essential matters and to make it possible for them to cooperate to protect their interests, and (3) to give the investors the services of a disinterested trustee and to assure them that their trustee will maintain high standards of conduct in administering his trust Thus the provisions of the act deal only with the covenants affecting the protection and enforcement of the rights of investors They have no bearing upon such matters as the desirability of the bond issue, adequacy of security, offering price, maturity date, interest rate or sinking fund provisions.

Provisions of the Trust Indenture Act

The Trust Indenture Act requires all trust indentures to include certain provisions and permits other provisions to be included

The following provisions are required

1 There shall be one or more trustees, at least one of whom shall be a corporate trustee subject to state or federal control or examination.

2. The corporate trustee must have a combined capital and surplus of at least $150,000 during the period of trusteeship.

3 The corporate trustee shall perform all trust duties and obligations and exercise the rights and powers of trustee unless prohibited by state law from so doing, in which event such acts shall be performed by a co-trustee

4. Where a trustee has, or acquires, a conflicting interest, he shall, within 90 days of discovering the conflicting interest, either eliminate it or resign, and if he does neither, he must notify the security holders within 10 days of the expiration of the 90-day period, whereupon any bona-fide holder of a security for at least six months may start removal proceedings

Conflicting interests of trustees include any of the following

a. Trusteeship under more than one indenture of the same corporation

b Interlocking relationships with the corporation as underwriter

c Beneficial ownership by the corporation or underwriter of voting securities of the corporate trustee

d. Beneficial ownership by the trustee of securities of the corporation or underwriter

e Ownership by trustee in a representative capacity of securities of the corporation or underwriter.

All of these conflicting interests are subject to qualification or exception under the terms of the act

5. The indenture shall state the percentage of securities owned which might constitute conflict of interest, but this statement alone shall not be construed as indicating either direct or indirect control sufficient to disqualify the trustee

6. If the trustee becomes a creditor of the corporation within four months prior to default or after default, he must create a special account and hold therein for his benefit and the benefit of the security holders

a. The amount of all reductions in the indebtedness made during the four months.

b. All property received in payment against the indebtedness or the proceeds of such property

7. The indenture must provide that the funds and property in the special account shall be divided between the trustee and the security holders, so that each receives the same percentage of their claims

8. The indenture must require the corporation to file with the trustee every six months, and at other times if the trustee request it, the names and addresses of the security holders, and the trustee is required to preserve in current form all such information which it receives as paying agent.

9 The trustee is required, when demand has been made by three or more security holders, to make available to them within five business days a list of all security holders or their approximate number, and to inform them of the cost of mailing a proxy if they so desire If the applicants request it, the trustee must mail promptly to all bondholders such proxy or other communication, after payment for the service has been made, unless within five days the trustee advises the Securities Exchange Commission that, in its opinion, such mailing would be in violation of the law or contrary to the best interests of the security holders If, after a hearing, the Securities Exchange Commission refuses to sustain the trustee's objections, the proxy or notice must be mailed

10. The indenture must require the trustee to send to security holders at least once a year a brief annual report setting forth

a. The trustee's eligibility and qualifications to continue as such

b. The character and amount of any unpaid advances made by it as trustee aggregating more than one-half of one per cent of securities outstanding, if the trustee claims a lien for such advances prior to that of the securities

c. The amount, interest rate, and maturity date of all indebtedness owing to it by the corporation, with a description of any collateral

d. The property and funds in its possession as trustee.

e. Any releases, or releases and substitutions of property not previously reported.

f Any action taken by the trustee which will materially affect the securities

g If the trustee has released, or released and permitted substitution of property, having a value of 10 per cent or more of the face of securities outstanding, or has made unpaid advances since the last annual report amounting to 10 per cent of the face of securities outstanding, then an interim report so stating the facts must be sent to security holders within ninety days of such event.

11 The trustee must transmit reports by mail to all registered security holders.

12 The trustee must file a copy of each report with each stock exchange upon which the securities are listed and with the Securities Exchange Commission.

13. The indenture must require the corporation to file with the trustee copies of annual reports and other information which it is required to file with the Securities Exchange Commission under Sec. 13 or 15(d) of the Securities Act.

14 If the indenture is secured by a mortgage or pledge of property, the corporation must furnish the trustee immediately after the indenture is executed and annually thereafter, an opinion of counsel that the mortgage has been properly recorded or that recording is unnecessary

15 The indenture must require the corporation to furnish the trustee with evidence showing that the corporation has complied with conditions precedent to authentication and delivery of securities, release and substitution of property subject to the mortgage, satisfaction and discharge of the indenture

16. If the indenture is secured by mortgage or pledge of property or securities it must require the corporation to furnish the trustee with a certificate of fair value of any property or securities to be released from the lien of the indenture and a statement that such release will not impair the security under the indenture

Where deposits of collateral with the trustee is to be the basis for the issue of securities under the indenture, the withdrawal of cash, or the release of property or other securities, a certificate of appraisal by an expert of the fair value of the securities deposited must be submitted to the trustee

A similar certificate of appraisal by an expert must be submitted to

the trustee where securities are to be issued or cash withdrawn or property or securities released, on the basis of subjecting newly offered property to the lien of the indenture

17 The trustee must examine the evidence submitted as certificates of fair value by the corporation to determine whether or not such evidence conforms to the requirements of the indenture.

18 The indenture must require the trustee to give security holders notice of all defaults known to the trustee within ninety days after they occur, but it may provide that except for default in interest, principal, or sinking fund, the trustee may withhold notice if it considers such action to be in the interest of security holders

19 In case of default, the trustee is required to exercise those rights and powers vested in it with the same degree of skill and care as a prudent man would exercise in his own affairs under similar conditions.

20. The indenture may not contain provisions relieving the trustee from liability for negligent failure to act or wilful misconduct This provision is qualified as follows

- *a.* Prior to default the trustee is only liable for performance of duties specifically stated in the indenture
- *b* The trustee may rely upon certificates and opinions furnished it according to the indenture.
- *c.* The indenture may provide protection to the trustee against liability for errors of judgment made in good faith, unless the trustee was negligent in ascertaining the facts upon which decision was based.
- *d* The trustee may be protected in the indenture against liability taken or not taken in good faith at the request of holders of not less than a majority in principal of the securities as to the time, method, and place of conducting any proceeding for any remedy available to the trustee or the exercise of any power conferred by the indenture
- *e.* No trustee under an indenture which has qualified shall be liable because the indenture does not comply with the act or any rule or order issued under the act

21. Trustees, in order to qualify, must consent to the use by the Securities Exchange Commission of information obtained by the Com-

mission from the Treasury Department, Comptroller of the Currency, Federal Reserve Board or banks, and Federal Deposit Insurance Corporation, as a basis for determining their qualification.

22 The indenture must provide that the right of security holders to receive payment of principal and interest or to sue therefor may not be impaired, except as follows

> *a* Holders of 75 per cent in principal amount of bonds outstanding may, on behalf of all holders, consent to the postponement of interest payment for three years.

23 The indenture must provide that each paying agent notify the trustee of any default by the corporation and hold all cash in his possession for the payment of principal and interest in trust for the security holders and the trustee.

24 The indenture must authorize the trustee to recover judgment for the whole amount of principal and interest in default and to file proofs of claim in judicial proceedings relative to the corporation.

25 The indenture must provide that if any of its provisions limits, qualifies, or conflicts with any provision required by the act to be included in the indenture, the required provision will govern.

Optional Provisions

1 The indenture may contain a provision excluding the ownership by a trustee of other securities of the same corporation from constituting a conflicting interest, as well as certain creditor relationships with reference to preferential collection of claims by the trustee against the corporation

2 The indenture may authorize holders of a majority in principal amount of bonds outstanding to direct the time, method, and place of proceeding for a remedy of the trustee, or to consent to a waiver of a partial default

3. The indenture may contain provisions limiting or denying the right of a security holder to bring suit, if and to the extent that such suit would result in surrender or impairment of the lien of the indenture.

4 The indenture may also contain any other provision which is not in contravention of any provision of the act

Civil and Criminal Liabilities

The act contains civil and criminal liabilities similar to those contained in the Securities Act of 1933 The act makes it unlawful for any person in issuing or selling a security to state or imply that any action or failure of the Securities Exchange Commission to act means that the Commission has passed upon or approved any trustee, indenture, or security issue, or that if the Commission has examined any statement or report filed with it, such examination constitutes the document as accurate or not false and misleading

a False or misleading statements contained in any application, report, or document are subject to the civil liabilities of the Securities Exchange Act of 1934, which permit the person who purchased on the strength of such statements and suffered loss to recover in damages the amount of his loss from those who made the statement, unless they can prove that the statements were made in good faith and without knowledge that they were false or misleading

b. For wilful violation of any provision of the act or any rule thereunder, or, for wilfully making any untrue statement of a material fact in any application or document, or for omitting to state any material fact necessary to avoid making other statements misleading, the act provides for a fine, not to exceed $5,000, or imprisonment for not more than five years, or both.

Powers of the Commission

The Commission only has the power to see that indentures conform to the prescribed standards It may make rules and regulations necessary to carry out the provisions of the act It may refuse to permit a registration statement to become effective if the security is not to be issued under an indenture, or if the indenture does not conform to the act, or if the trustee is not eligible or has any conflicting interest The Commission has the power to investigate matters concerning indentures and trustees. Supervisory agencies of the Federal Government, such as

the Comptroller of the Currency, are required to make available to the commission information relating to trustees and to examine trustees to obtain information for the use of the commission

One result of the act has been an increase in corporate trustee's fees of from 20 to 40 per cent depending upon the size of the issue This was to be expected, due to the increased volume of routine work required of trustees and the fact that the act requires the trustee to be a trustee in fact and assume full responsibility for his acts in that capacity The commission indicated that the act would be liberally interpreted It has gone into effect with far less criticism than most of the New Deal legislation It is too early to attempt an appraisal of its operation

CHAPTER 9

TYPES OF MORTGAGES AND BOND RESERVES

American financiers are committed to the idea of specific security sustaining bond issues. Until recent years it has been difficult to sell debenture bonds (plain bonds without specific security) at values commensurate with their security Laws regulating the investment of the funds of savings banks and trust funds usually stipulate first-mortgage bonds. In Great Britain, on the other hand, bonds without specific lien security are common

Objects Governing Selection of the Type of Bond

Recognizing the preference of the American investor for mortgage bonds, directors, in making a plan for the raising of money, must keep in view the following objects (1) They must obtain for the corporation the money required, (2) they must procure this money at the lowest possible cost consistent with safety, (3) they should provide, if possible, for subsequent issues of bonds secured by the same mortgage.

Preference for First-Mortgage Bonds

Corporate directors must face the fact that the investor will pay a higher price for first-mortgage bonds than for any junior security *issued by the same company* Of two bonds of equal security, so far as earnings are concerned, one secured by a first and the other by a second mortgage on the same kind of property, the first-mortgage bond will always be preferred This preference is easily explained In the case of bankruptcy and reorganization, the first-mortgage bonds are in a position of advantage Up to their full par value based on the earning power of the property set aside to secure them, they must be protected Before the holders of second-mortgage bonds can enforce their lien and sell the property that secures their bonds, they must satisfy the claims of the first-mortgage bondholders, either by paying them or by satisfying them with new bonds of equal or greater security. Otherwise, the first-mortgage bondholders may force the property that secures the obliga-

tion to a judicial sale, and buy it themselves, using their bonds to pay for it The investor's first concern is the safety of his principal. He wishes the utmost protection This protection, the first mortgage, as distinct from any junior lien, gives him[1]

Next to first-mortgage bonds, in grading secured issues, the investor will rank collateral trust bonds Here the security consists of first-mortgage bonds or dividend-paying stocks The borrowing company can pay the interest, if need be, out of its other revenues, without using any of the interest or dividends produced by the bonds and stock deposited as security, without depending, that is to say, upon the income produced by the collateral Next, he will rank bonds secured by leases and finally, debenture bonds The directors of a corporation proposing to issue bonds will give the bonds, if possible and necessary, the security of a first mortgage. If this can not be done, they will adopt some form of bond secured by a first lien, either on securities owned or on rights under leases In case neither method is available, and also as additional security, 'the corporation may assume the indirect conditional obligation of a guarantor or indorser of bonds which are sold for its benefit

Amount of Bonds Authorized and the Property Clause

Every corporate mortgage contains a covenant regarding the amount of bonds permitted to be issued under the lien of the mortgage This covenant will be found in that section of the mortgage titled "Form, Execution, Registration and Exchange of Bonds" Where the mortgage limits the amount of bonds to be issued, the mortgage is said to be closed. For example, the indenture securing first mortgage bonds may authorize an issue of $25,000,000 This is a closed mortgage, as no more bonds than the amount specified may be issued. The entire $25,000,000 of bonds need not be initially sold, but that amount may never be exceeded If, on the other hand, the mortgage does not specify a dollar limit to the amount of bonds permitted to be issued, it is an open mortgage As an illustration, the mortgage may provide that,

[1] Many exceptions can be cited to this rule Some of the best bonds are secured by general mortgages—that is, first, second, and third mortgages In these cases, however, the first mortgages are usually for small amounts, calling for such moderate payments in relation to the surplus earnings of the company that the investor disregards the prior liens A tendency is visible, however, in recent years to retire, as far as possible, these underlying liens, in order to bring the mortgages securing the large issues of general mortgage bonds nearer the property.

additional bonds may be issued under this indenture in subsequent series, having such rates of interest, maturities and other provisions provided in the indenture as the directors may from time to time approve (a) to refund a like principal.. (b) for not in excess of 75 per cent of the cash "cost" or fair value (whichever is less) of the additional property acquired subsequent to August 1, 1926 when consolidated net earnings for twelve consecutive months within the fifteen months next preceding shall have been at least equal to twice the annual interest charges on all bonds outstanding under the indenture including those for which application is made

These terms "open" and "closed," which are frequently encountered in bond descriptions, refer to the amount of bonds authorized under the contract of debt.

Each mortgage also contains a clause or clauses enumerating and describing the corporate property which is to serve as specific security for the bonds to be issued These clauses are usually entitled "Granting and Pledging" clauses. Here again there are two types (1) the inclusive mortgage which pledges as security all property at the time owned by the borrowing company and, in addition, all property thereafter to be acquired; and (2) the exclusive mortgage, wherein the lien is limited to specified and described property and does not include any property which may be thereafter acquired by the corporation. There follows a typical inclusive property clause

Together with all the branches, extensions, and sidings thereof and therefrom, and all the lands and rights of way used and occupied, or surveyed, laid out, or intended to be used and occupied for the said railroads, branches, extensions, and sidings, with all the railroad tracks, buildings, and improvements thereon, and all and singular the lands, bridges, trestle works, wharves, shops, stations, depots, engine houses, engines, cars, rolling stock, furniture, equipments, and generally all and singular the estate, real and personal, of the said Railroad Company, *whatsoever and wheresoever, now owned or hereafter to be acquired by it.*[2]

An exclusive property clause may be illustrated by the following quotation from one of the Union Pacific mortgages

All and singular the several lines of railroad, property, and premises belonging to the Railroad Company which are particularly described as follows .

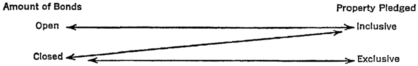
[2] Italics the authors'.

[There follows a detailed description of property pledged.] Together with all additions, lands, terminals, yards, bridges, tracks, rights of way, trackage rights, buildings, telegraphs, shops, elevators and other structures and fixtures, easements and leaseholds, corporate rights and franchises, now held or acquired or *hereafter held or acquired for use in connection with the said lines of railroads, specifically above described.*[8]

From the above exclusive clause there has been eliminated for want of space the detailed descriptions of those portions of the property which were to serve as security for the bond issue. Each of these properties is, of course, enumerated and exactly defined, the description covering many printed pages in the mortgage.

Since every corporate mortgage contains some provision covering the amount of bonds authorized and also a statement regarding the property (title to which has been conveyed as security), they may be classified by some combination of the terms above described. The following diagram summarizes the classification with respect to amount of bonds authorized and extent of property pledged, and indicates the possible combinations.

Classification of Mortgages with Respect to Amount of Bonds Authorized and Property Pledged



Thus every mortgage will be one of three types: (1) closed exclusive, (2) closed inclusive, and (3) open inclusive. The fourth possible combination, open exclusive, is never encountered. It would be difficult, if not impossible, for a corporation to issue bonds with no limit to the amount, secured by a restricted fund of property value.

The Closed Exclusive Mortgage

The closed exclusive mortgage is the oldest type. From the viewpoint of the borrowing corporation, this type enjoys two advantages. It does not encumber, in advance, any property which the corporation may acquire in the future. Later acquisitions are free to be used, should the

[8] Italics the authors'.

need arise, as separate pledges for later bond issues Secondly, if the property value is substantially in excess of the bond issue and company earnings show a satisfactory margin of safety, such bonds can be sold at higher prices and with lower interest rates, thus meeting the second object governing the selection of the type of bond—the lowest possible cost It is customary, under closed-exclusive mortgages, for the entire amount of bonds authorized to be immediately sold

The closed exclusive mortgage may be disadvantageous to the corporation This has been true with some of our American railroads, whose financial structures after many years have become a patch-work of first liens on various sections of the road, with extensions, branch lines and terminals partially financed by closed exclusive mortgage issues The later issues, in many cases, are not as desirable as the original main line bonds, and therefore the cost of borrowing is increased If, at a later date, a loan is needed and no new property of sufficient value is available, the corporation is forced to resort to a general or blanket mortgage, which is, so long as the underlying bonds remain outstanding, only a second lien. Here again, the cost of borrowing is raised and the bonds are not acceptable to many large investors If the corporation will insist upon a callable clause in the closed exclusive mortgages, then instead of the general mortgage, a first-mortgage issue can be sold and a part of the proceeds used to retire the existing first mortgage, and the difficulty of selling junior (general mortgage) bonds can be avoided. Few bond issues are now made without the callable feature

Advantage of Closed Inclusive Mortgage

The closed inclusive mortgage has been of advantage to corporations whose financial history has been brief, and whose credit therefore has not yet been established When a company executes a mortgage of this type as security for a bond issue it says, in effect, to the bond purchasers, "We have borrowed from you a sum of money which is amply secured by pledge of the property we now own, but beyond that, we promise that not only will the amount of the debt be not increased beyond the original authorization, but every piece of property which we may buy or acquire during the years that your bonds remain outstanding will likewise become a part of our property pledge, and so add to the margin of security for your bonds." Stated thus, one might well ask why a corporate management would be so magnanimous toward its creditors.

The answer is, in most instances, that such mortgages were created by young corporations, whose earnings had yet to be established, and whose future was uncertain If they were to borrow at all at a cost which would not be prohibitive, they were forced to offer the maximum security

Some corporations, not necessarily weak, have executed closed inclusive mortgages where the amount of bonds authorized was substantially in excess of the amount which they desired to issue immediately A company may authorize $50,000,000 of bonds, of which $5,000,000 would be the initial issue. This is a wise precaution, for it enables a company to arrange in advance for further first-mortgage bonds Since all after-acquired property will come under the lien of the same mortgage, additional bonds of the same issue may be sold, as capital needs may dictate and the earnings of the company may warrant. This provision for future issue of bonds under a mortgage, up to a fixed limit, is called a bond reserve. The one advantage of the closed inclusive mortgage from the viewpoint of the corporation is that the company can borrow at a more favorable cost. Based upon the theory of constantly increasing property value as security for the debt, and the likelihood that as assets are added to, the earnings of the corporation will grow apace, and thus strengthen the margin of safety for the bonds, they can be sold at a price close to par, and with lower interest rates than the record of the corporation might otherwise justify. The bond reserve which may be provided for in this type of mortgage is an advantage to the company, since subsequent issues will be first-mortgage bonds of equal rank with the initial issue, and should sell at high prices The closed inclusive mortgage is an illustration of the influence of financial expediency upon capital structure The corporation, desiring to procure capital by the issue of bonds, offers as many advantages to the bondholder through the terms of the mortgage as are necessary to produce a ready market at a price acceptable to the company.

Objection to Closed Inclusive Mortgage

That the closed inclusive mortgage might be disadvantageous to the issuing corporation is not difficult to see. Some mortgages of this type have been so rigidly drawn that the issuer has been restricted in its future ability to borrow This is particularly true if the bonds issued thereunder are not callable No corporation whose management gives sufficient thought to future expansion and new capital acquisition for the

purpose, should consent to a closed inclusive mortgage, unless they reserve the right to call and retire the bonds at their discretion. Mortgages of this type have been so drawn that the property clause includes not only all real property subsequently acquired, but all personal property as well, including securities of subsidiaries or other corporations Such a mortgage automatically reaches out and absorbs everything of value which comes into the possession of the issuer A recent case in point is that of the Chicago, Burlington and Quincy Railroad In February, 1937, the company arranged to issue $7,080,000 of equipment trust notes The sale of the notes had been arranged for and publicly announced, when it was realized that the terms of an existing inclusive mortgage might be held to include in its lien the new equipment about to be purchased. The road decided to cancel the sale of the notes and make other arrangements for financing the purchase of the equipment.

There is a further disadvantage in connection with the bond reserve Should all of the reserved bonds be issued before the term of years for which the bonds were issued, expires, the corporation, should it desire to borrow further, will be forced to resort to junior bonds In such a case the cost of borrowing will be increased. Another alternative method of bond financing, when the above difficulty exists, is to create a new corporation which would issue first-mortgage bonds secured by the new property to be acquired. These bonds might be guaranteed by the parent and offered for sale to the public, or the parent company may take the bonds and pledge them as security for an issue of its own collateral trust bonds

If none of the above alternative methods of borrowing are considered acceptable, there still remains the possibility of raising additional capital by stock issue. Preferred stock or common stock might be sold The success of further stock sale will depend, of course, upon past and present profits If none of these devices can be used, the company, still in need of capital, might resort to a comprehensive readjustment of its capital structure, retiring all senior bond issues which are callable, thus releasing the property pledged to secure them, revamping its capital stock issues as expediency might suggest, and arranging for a new mortgage bond issue which will give them the additional capital desired This device will only be used when all others are unavailable

The Open Inclusive Mortgage

The open inclusive mortgage, as its title indicates, contains no upper limit to the aggregate amount of bonds which may be issued thereunder, and provides, with respect to specific property pledged, that "all property now owned or hereafter to be acquired" shall come under the lien of the mortgage. The initial issue of bonds under such a mortgage is usually designated as Series A Provision is made for subsequent series to be issued as the need of the corporation for further capital may arise For example, the mortgage of this type drawn in 1927 by the Duquesne Light Company to Union Trust Company of Pittsburgh states that "except as herein or may be by law provided, the amount of bonds which may be authenticated and delivered hereunder *is not limited*,[4] provided, however, that the aggregate principal amount of bonds, or of any series of bonds, which may be so authenticated and delivered hereunder may at any time, at the election of the company, evidenced by an instrument supplemental hereto executed by the company and delivered to the trustee, be limited to such sum as may be specified in such instrument" The only limits fixed are those placed upon the company by the laws of the state in which incorporated and by the stockholders who have the right (not contrary to law) to determine the maximum debt of their company. The same mortgage also states (Article 2, Section 9) that "at the option of the company, the bonds issued hereunder may be issued in one or more series, each series being designated by a letter of the alphabet, or by title, or by some other suitable designation" In a later section the mortgage states that "Series A bonds in the aggregate principal amount of $55,000,000 shall from time to time be authenticated and delivered by the trustee, upon the order of the company," and thus be issued by the corporation in its program of capital acquisition Here we have the essential provisions of an open mortgage—the statement that the amount of bonds is not limited and further provision for their issuance in series at the discretion of the company

The Duquesne Light Company mortgage here referred to is a first mortgage It is not only an "open" mortgage, but it is also "inclusive," and that fact is ascertained by referring to the section of the mortgage dealing with the pledge of property Here we find that the company has conveyed to the trustee as security for the bonds to be issued, not

[4] Italics the authors'

only one hundred eighty-nine specified parcels of improved and unimproved real estate owned by it, but all other physical property and appurtenances, the company's interest in certain valuable leaseholds and contracts, the stock which they own in designated companies for the purpose of control, and "all other property, real, personal and mixed, which the company may hereafter acquire or to which it may hereafter become entitled, whether acquired pursuant to its present charter powers or pursuant to such powers as they may be enlarged or hereafter exist . . . it being intended that all property, real, personal and mixed, of any and every kind and character, which the company now owns and all property which it may hereafter acquire, shall be subject to the lien of this indenture . . "

From the viewpoint of the corporation which desires to borrow and secure its bonds with a mortgage, the open inclusive mortgage is the best form No limit is fixed in the mortgage If the corporation prospers and grows, it may finance a substantial portion of its development by issuing new series of bonds under the same mortgage. All of these bonds of each series will be first-mortgage bonds, and all will be equally secured. No series, regardless of the date of issue, will take precedence over any other series. The corporation has avoided the difficulty of exhausting the bonds authorized under a closed mortgage, and thus being forced to borrow, if at all, by means of a second mortgage or a subsidiary company issue. In substance, the open inclusive mortgage enables a corporation, over the years, to borrow at the lowest cost which its credit standing or general financial condition will permit. The investor prefers first-mortgage bonds, and will pay a higher price for them with a given interest rate than he will pay for junior bonds The corporation issuing bonds under an open inclusive mortgage need never resort to junior bonds

CHAPTER 10

RESTRICTIVE COVENANTS IN MORTGAGES DEALING WITH BOND RESERVES

Providing for Future Capital Funds

In fixing the amount of bonds to be issued, provision should be made for probable future capital requirements. Under normal conditions, a corporation, if well managed, will expand its operations. It will increase the capital with which it began operations, in handling the increased volume of business which the growth of the country and the energy of its management will bring to it. If the capital of the company was originally obtained by an issue of bonds, it is likely to resort to its credit to provide funds for the enlargement of its plant. The closed corporate mortgage, however, is an obstacle to the subsequent sale of new bonds. When a mortgage authorizes $5,000,000 and no more, this amount can not be increased without the consent of the bondholders, which is seldom to be obtained. The corporation is not likely to be in a position to induce the bondholder to relax the obligation of his mortgage, to permit an increase in the amount of debt which the mortgage secures. Failing this provision, the natural method for the company to adopt in raising money for extensions, will be to mortgage these extensions, either directly or by organizing subsidiary companies to issue their mortgage bonds, usually secured also by the guaranty of the parent company. When the company is very strong, and its first mortgage debt is small in reference to its earnings, it may also raise money by a second or general mortgage, or by the sale of debenture bonds without specific security. These methods of providing money, however, are not so effective as the sale of bonds secured by a first mortgage on the entire property of the company. Any division of security by which one part of the property secures one issue of bonds, and another part secures another issue, is open to serious objections. In the event of trouble, a contest between the holders of the different issues of bonds is immediately precipitated. For the same reason, a sale of

junior bonds is always difficult, especially when the amount of senior bonds is large. These prior lien bonds hang like a dark cloud over the junior bonds which follow them. If such junior bonds are issued, they must be sold to carry high rates of interest, resulting in a burden to the borrowing company.

This situation violates the second objective of a capital set-up, which is to provide money at the lowest possible price. Provision may be made in the mortgage to secure all additional bonds following the original issue which are sold to provide funds to expand the property. These bonds, if issued under restrictions which preserve and increase the safety of their interest payments, carry interest rates equal to those obtained for the original issue; in fact, in many cases, because the business is older and better established, these later issued bonds carry lower interest rates. The purpose of such a mortgage is to preserve and improve the security by the expenditure of the proceeds of successive issues of bonds secured by the original first mortgage.

These objects may be achieved by employing either one of two devices: first, the bond reserve; second, the open mortgage. The bond reserve consists of an amount of bonds authorized under an appropriate mortgage, only a portion of which may have been originally issued, the balance having been retained for subsequent sale.

Restrictive Covenants Used to Preserve Security: Limitation upon Annual Issue

Bonds must be issued out of this reserve under certain restrictions, which are five in number. The five are not ordinarily found in any one mortgage. The first is the limitation on the amount of bonds which can be issued in any one year. The original authorization may be $10,000,000, of which $1,000,000 has been issued and $9,000,000 reserved. The business can earn interest and sinking fund on $1,000,000. The bondholders have no objections, and in fact, favor expansion of these earnings by additions to the property, through the sale of bonds out of the reserve. If, however, it is proposed to sell $2,000,000 or $3,000,000 out of this large bond reserve, the holders of the original bonds might lose confidence in the ability of the company to meet such a large addition to its fixed charges. This objection is met by a restriction on the amount to be issued in any one year. On the other hand, there is this objection to the restriction on an amount of bonds to be

issued in a single year, that it may delay and increase the cost of an expansion program which has been well thought out, and which is reasonably certain of success. The interest of the corporation, by this restriction, is to some extent sacrificed to the desire of bankers to maintain the confidence of bondholders.

Cost of Property Restriction

The second restriction on the issue of bonds out of a reserve is based on the cost of the property purchased or constructed with the proceeds of the bonds It is customary, in withdrawing bonds from a reserve, that the company should first, out of funds obtained from other sources, build or buy the desired property The usual method is either to use the surplus cash which the company may have, or to make bank loans After the property is built, the application is made to the trustee of the bonds and, in case of a public utility company, to the regulatory commission, to deliver, according to the terms of the mortgage, bonds equal to two-thirds or three-quarters of the certified cost of the additions or improvements This certification consists of statements signed and attested, usually by an officer of the company—the president, or in some cases the Chief Engineer—which sets forth in as great detail as the mortgage provides, the cost of the property which is to be partially paid for out of the proceeds of the bonds which it is now proposed to withdraw from the reserve. When satisfied that the requirements of the mortgage have been met, the trustee certifies and delivers the amount of bonds—say $750,000—against $1,000,000 of property cost. The bonds are then delivered by the corporation to the bankers who pay for them at the agreed price. The funds are used either to pay off the temporary loans incurred to make the property expenditure, or to reimburse the treasury for the cash already withdrawn for this purpose.

The justification of this cost of property restriction rests upon the assumption that the expenditure of $1,000,000 in enlarging the property of the company will add, say, at least $100,000 to the earnings of the company. The only justification for making the investment is to increase the earnings, and the earnings are supposed to rise with the enlargement of the property In most cases, this assumption is correct. Such an investment will not be made unless the responsible officials of the company have satisfied themselves, by careful investigation, that, either by increasing the gross revenue of the company or by reducing its

operating expenses, the earnings available for fixed charges will be increased by at least double the amount of fixed charges on the new bonds.

There is an objection to the cost of property restriction It is possible for companies interested in drawing down the largest possible amount of bonds to pad and inflate their property values by over-appraisal or the establishment of fictitious values in such a manner as to obtain not 66⅔ per cent or 75 per cent of the cost of the new property, but 100 per cent Dewing, in his *Financial Policy of Corporations*, explains this method of evading the restrictions of the mortgage as follows

> The abuses of the restriction on cost are conspicuously true as regards the cost of property restrictions in public utility issues The provision restricting the issues of new bonds to 70 or 80 per cent is susceptible of manipulation by an unscrupulous management. By making heavy charges for engineering services, heavy intermediate profits on materials furnished, and fictitious valuations for new real estate, either through the directors and their associates, or through subsidiary or allied corporations, it is possible to so inflate the construction costs that the 70 or 80 per cent which the terms of the open mortgage cover will equal the entire actual cost [1]

Assuming that property does furnish the security for bonds, so far as property contributes to earnings, the issue of additional bonds secured by a lien upon the enlarged property of the borrowing company will reduce the margin of safety, unless the same relationship between the original cost of the property and the original bond issue is maintained throughout all subsequent issues of bonds. For example, if the company, in the beginning, issued bonds up to half the cost of the property, and if the mortgage securing these bonds provided for subsequent issues up to three-fourths of the cost of additions to the original property, the margin of security in the property of the company is reduced by every subsequent issue of bonds.

Earnings Restriction

The third restriction under which bonds may be issued out of the reserve is that the earnings of the company shall show a stipulated margin over its fixed charges, including the interest charges on the bonds about to be issued, even though the property to be purchased

[1] Dewing, A S, *Financial Policy of Corporations* (The Ronald Press Company, New York, 1926), p. 92

or constructed, and to be partially paid for out of the proceeds of the sale of these bonds, has not yet come into "bearing" Sometimes the earnings restriction is coupled with the cost of property restriction so that bonds can be issued, for example, up to 75 per cent of the cash cost of additions and improvements, only in case the net earnings for the preceding twelve months are equal to or exceed an amount which is double the interest charge on the total amount of bonds outstanding, including those to be issued This earnings restriction, whether or not coupled with the gross cost of property restriction, is superior to the restrictions previously described. It compels the company to demonstrate to the trustee of the mortgage its ability to pay the interest on the new bonds, with a substantial margin of safety, before the corporation is subjected to the liability of the new fixed charges.

It is important, and recent mortgages have gone into much detail in this matter, that the method of calculating the earnings governing this restriction should be carefully defined to avoid the danger that the company, as it might inflate the cost of the property, might overstate the amount of earnings. Not to anticipate too much the discussion of earnings which will be found in later chapters, we may point out that the common method of inflating earnings is to omit from the statements an adequate provision for the maintenance of the plant, for depreciation, and for the depletion of certain kinds of physical assets such as lumber, coal, or ore, which are exhausted by the operations of the company

Net Current Asset Restriction

The fourth common provision for the protection of the bondholders stipulates that a certain surplus of current assets over current liabilities should at all times be maintained The usual term employed to describe this surplus is net current assets, and the formula by which the amount of net current assets is determined is as follows

> Current assets (cash, plus accounts and notes receivable, plus inventories, plus investments and occasional prepaid expenses and charges), minus current liabilities (accounts and notes payable, accrued expenses and taxes, and any dividends declared, but as yet unpaid), equals net current assets.

A large amount of current assets over current liabilities is supposed to insure a company against financial embarrassment. Here, again, the

protection given to the bondholder by the current assets restriction may be exaggerated. Some of these current assets must be reserved for the operation of the business, such, for example, as raw materials and partly finished products. They are not available to pay debts (unless they are of standard grade with an active market) until they have passed through the productive process, and, in the form of finished products, have been converted into accounts receivable, and finally into cash A large inventory may be the means of securing a bank loan, but it gives no assurance of ready cash when the corporation may most need it, such, for example, as the due date of a large batch of interest coupons A typical current asset restriction for the issue of bonds out of the reserve was contained in the mortgage securing the \$10,000,000 of 5 per cent gold bonds issued by the Republic Iron and Steel Company. Here certain inventories were excluded from the asset calculation, thus partially avoiding the weakness just discussed The covenant provided as follows

> The net cash and quick assets over and above liabilities, other than the \$10,000,000 of bonds and the interest thereon, shall never be less than \$6,500,000 while any of the said issue of bonds remains outstanding, until the total amount of such issue of \$10,000,000 not canceled, shall be less than \$6,500,000, and thereafter shall never be less than the amount of such \$10,000,000 of bonds at any time uncanceled By the phrase "cash and quick assets" is meant cash in bank, good accounts and bills and notes receivable, contract notes, or similar or other securities received on the sale of products of the Republic Company, raw material, manufactured products (it being understood that the material shall be figured at actual cost without interest if cost is below the market value thereof at the time of the valuation thereof hereunder, but at market value if at such time below cost thereof) It is expressly understood and agreed that in the term raw material no ore or coal shall be included except such as has actually been mined and is then on the surface of the mines available for shipment by rail or in transit or at upper or lower lake docks, or at works

In theory, the corporation will always have in its possession cash or other current assets equal to a designated percentage of the total amount of bonds outstanding under the terms of the mortgage, the purpose again being to preserve liquid security for the benefit of the bondholders The greatest danger in a restriction of this character will arise where the current assets consist of "dead" inventory, and accounts and notes receivable, which, while still classed as good and collectible, can not

be turned into cash in order to meet the due date of interest coupons, or the maturity date of a portion or all of the outstanding bonds.

Restricting Bonds to a Percentage of Capital Stock

The fifth restrictive covenant frequently found in mortgages containing bond reserves, designed to prevent excessive issue of bonds, provides for limiting the total amount of bonded indebtedness to some fixed percentage of the total capital stock outstanding at any time For example, the Pennsylvania Railroad general mortgage provides that, "At any one time outstanding, including bonds reserved to retire prior debt, may not exceed the aggregate par value of the then outstanding paid-up capital stock of the company" With a restriction of this nature in the mortgage, the bonded debt of the corporation can only be increased proportionately to an increase in the capital contributed by the stockholders as owners through additional stock purchases, or by the process of capitalizing earned surplus by means of stock dividends In theory, the debt of a corporation is protected by the capital contributions of stockholders. If they have advanced substantial amounts of capital, their share will act as a cushion to absorb any shrinkage in the value of assets The stockholders' "equity," as it is termed, affords a factor of safety for the bonds

Some, or conceivably all, of these restrictive covenants can be included in mortgages, whether they provide for a limited bond reserve or are of the open-end type Their efficiency as protections to bondholders depends upon the adherence by the management to the letter of these restrictions Restrictions add to the salability of the bonds They protect the bondholders, however, only to the extent that they are neither evaded nor violated.

CHAPTER 11

COLLATERAL TRUST BONDS

A majority of the bond issues of American corporations, both in number and amount, are secured by mortgages on real estate In many cases, however, due both to necessity and design, the corporation secures its bond issue by the pledge with the trustee of collateral security—stocks, bonds, leases, and other forms of personal property When the only assets of the company consist of the stocks and bonds of other companies, this form of security is, of course, essential when secured bonds are issued Furthermore, many large companies, in the course of their development, have acquired, along with an extensive physical plant, the securities of other companies which they hold, as a rule, not for investment, but for control of the corporations which have issued these securities. The Pennsylvania Railroad, for example, in its balance sheet for December 31, 1937, shows the following holdings of securities Investments in affiliated companies Stock, $437,000,000, Bonds, $22,000,000, Notes, $32,000,000; Advances, $147,000,000; Other Investments, $66,000,000. The security holdings of the New York Central were $415,000,000

Illustration: Collateral Trust Bond

The structure of the corporation may be very complex. As it grows, it may accumulate large amounts of valuable stocks and bonds of subsidiary companies acquired or organized to assist its development, which it can use as security for loans, either in connection with a mortgage on real property, which is known as a mixed mortgage, or as a simple collateral trust indenture. The general form of the collateral trust indenture is the same as that of the mortgage on real property, with one distinction, which arises out of the fact that in the mortgage on real property, the possession of the property remains in the mortgagor. The trustee, as we have seen in the discussion of the corporate mortgage, has, in fact, comparatively little to do with its administration and management. With the collateral trust indenture, however,

the trustee is in physical possession of the security. The stock certificates and the bonds which make up the security, are in the vaults of the trustee. The dividends and interest on these securities furnish a part, and sometimes all, of the means of paying the interest on the bonds which these stocks and bonds are pledged to secure The duties of the trustee in the administration of this trust are largely conditioned by this fact. If the security consists of stock, the trustee may, as additional protection to the bondholders, transfer to his own name, although this is not usually done, the title to the certificates, physical possession of which he holds. As the registered owner of this stock, the dividends would then be paid directly to the trustee, and he would disburse them in accordance with the terms of the indenture In the case of default on the bonds secured by stock certificates, it is the duty of the trustee, if he has not previously arranged for the transfer of the stock to his own name, immediately to do so And in that event, the dividends would be paid directly to him and held by him for the benefit of the bondholders.

In the absence of such formal transfer, the dividends are paid directly to the pledgor corporation. In case transfer is made, the matter of voting this pledged stock arises. It is provided in the collateral trust indenture that, in the absence of default, the trustee shall execute his proxy on request to the corporation, so that the stock may be voted by the owner-pledgor corporation at any regular or special meeting of the company.

Protection of Collateral Pledged (Stock)

These shares of stock are evidences of ownership in other corporations usually controlled by the pledgor corporation through the ownership of these pledged stocks. It is necessary, for the preservation of the security, that the pledgor corporation should agree with the trustee to so use its stock control as to conserve the value of the pledged stock. The pledgor corporation usually agrees not to permit any company which it controls and whose stock is pledged to the trustee, to make any additional issue of stock, unless a percentage of the new stock corresponding to the percentage already held by the trustee is added to the collateral in the trustee's hands If the companies issuing the stock and controlled by the pledgor company, have any surplus accumulated out of profits, the pledgor company should agree that this surplus should not be dimin-

ished so long as the collateral trust bonds are outstanding, since that would impair the value of the pledged stock The pledgor company also should agree to cause all necessary repairs, renewals, and replacements to be made by the companies issuing the pledged stocks out of their earnings, and that it will not permit the sale by any companies whose stock is deposited as collateral security for its own bonds, of any part of their property, unless a percentage of the proceeds of the sale corresponding to the percentage of the stock so pledged, is deposited with the trustee as compensating security

Another covenant frequently found in collateral trust indentures under which capital stock of subsidiary corporations is pledged, provides that if any of the properties of the subsidiary corporations have been leased to another corporation, such leases are immediately terminable by the lessor, in the event that the stock of companies so pledged is sold because of default on the collateral trust bonds. The reason for this provision can be understood when it is realized that, should default occur on the collateral trust bonds, the trustee, already in possession of the collateral, is given the power under the indenture to sell the stock Should an attempt to sell the stock be made, it would be difficult to procure a purchaser, if the property of the company whose stock was to be sold is under the domination of another corporation by means of a long-term lease, running perhaps for 99 or 999 years Such leases are quite common in railroad consolidation. After a working control of the voting stock has been acquired in another company, it is customary to further strengthen the consolidation by means of a long-term lease of the properties of the other company.

Furthermore, if the trustee can not find a purchaser for the shares he holds, the collateral trust bondholders would find themselves in possession of the stock of a corporation whose property, under the terms of a lease then in effect, would be so dominated by the lessee that they would perhaps enjoy no benefits from their ownership This provision applies to leases entered into after the execution of the collateral trust indenture. It does not, of course, apply to leases pre-dating the execution of the indenture.

Protection of Collateral Pledged (Bonds)

When the pledged security consists of bonds, the pledgor company is sometimes required to deposit, along with the bonds, stock represent-

ing a controlling interest in the company issuing the pledged bonds The purpose of this provision is to prevent the company pledging the bonds from doing anything which might impair their security Such impairment of the security might be

1 The violation of any covenants in the indenture securing the bonds deposited as collateral. The trustee of the collateral trust bonds has no control of, or responsibility for, such items as maintenance and renewals, or the performance of franchise and tax obligations by the companies which have issued the bonds pledged as collateral Since neglect of any of these covenants already entered into with another trustee might seriously impair the value of the bond collateral, the attempt is made to supplement the covenants of the company pledging the bonds by the conveyance of title to the stock, which evidences the control of the companies issuing the pledged bonds.

2. Mortgages under which bonds are issued may provide for the issue of amounts of bonds additional to the original amount all or a part of which may have been pledged as collateral security Where such additional amounts are provided for, the pledgor of the bonds, if it controls, through stock ownership, the policy of the companies issuing the pledged bonds, agrees that these controlled companies shall not increase the amount of bonds outstanding of the issue pledged, unless the same percentage of the additional bonds so issued shall be deposited with the trustee of the collateral trust bonds as represents the original percentage of the bonds so deposited at the time of the execution of the indenture. If, for example, a company has pledged 90 per cent of bonds issued under a mortgage which allows the issue of $5,000,000 of additional bonds secured by the mortgage, 90 per cent of such additional issues should be deposited with the trustee. Where large percentages of bond issues are deposited under a collateral trust indenture, the effect of this restriction is to restrict future bond financing by the issuing companies, except by the issue of bonds of a lien inferior to those of the pledged bonds

Observance of these covenants can be much better secured, if stock representing a controlling interest in the companies issuing the pledged bonds is deposited with the trustee, than if the stock is left without restriction in the possession of the company which has pledged the bonds as security for its own obligations.

Mortgage vs. Collateral Trust Security

There is a basic difference between the security furnished by collateral, either stocks or bonds, and the security furnished by a mortgage on physical property. As long as the borrowing company can pay the interest on its collateral trust bonds, the stipulations of the indenture are of no importance. The trustee of the collateral trust indenture is provided with funds with which to meet the interest and sinking fund payments When the bonds mature, arrangements are made with the borrowing company, either to repay the bonds or to replace them with another bond issue The collateral trust indenture, in the absence of default, does not require the assertion of any of the reserved rights of the trustee. In the event of default, however, for example on bonds secured by stock, then it is the obligation of the trustee to assert his rights of ownership, to transfer the stock to his own name, to receive any dividends which may be paid on this stock, to vote the stock according to his best judgment, revoking any proxies which he may have issued to the borrowing corporation which is in default, and, in general, to exercise all the rights of ownership connected with the pledged stock.

If the interest on any of the pledged bonds is not paid, and if the collateral trust bonds are in default, it is the duty of the trustee to exercise his rights as a bondholder, either by instituting foreclosure proceedings when properly authorized by the stipulated percentage of holders of the pledged bonds, and when properly indemnified for any risks which he may assume, or by participating in reorganization proceedings of the company issuing the pledged bonds

The trustee's final remedy, in the event of default on bonds secured by stock or bond collateral, is to sell the collateral. His freedom of action in this regard is much greater than that of the trustee of bonds secured by a mortgage on real property In the case of a real property corporate mortgage, the court, in the event of default, usually takes control of the property in bankruptcy proceedings, and may appoint a receiver or bankruptcy trustee The trustee of the bonds secured by a mortgage must govern his actions by the will of the court, and he can not sell the property without the court's consent. In the case of bonds secured by collateral, however, the collateral is not under the control of the court, and there is no way in which the court can get possession of it It is

personal property in the possession of the trustee. While the court may enjoin the sale for a limited time, in order that no rights involved may be irreparably damaged, yet the injunction is only temporary, and eventually the trustee may dispose of the collateral in the best possible manner.

This power of the trustee was recently illustrated, although on a straight collateral loan, by the efforts of the receivers of the Mid West Utility Company to prevent the sale by certain New York banks of large amounts of collateral deposited to secure loans. The sale was postponed by injunction, but after the court had determined that the banks were innocent holders for value of the collateral, they were allowed to proceed with the sale

Generally speaking, the court will not interfere with the sale of collateral deposited, either with the lender or with the trustee as representing a group of lenders, in the event of default Of course, the amount of money which the trustee may secure for the bondholders by such a sale is uncertain It usually happens that the trustee participates in some reorganization or readjustment of the debtor corporation in order to secure for the bondholders a larger amount of value than could be obtained by a sale for cash

In disposing of collateral, the trustee has the utmost freedom of action He may sell it at public or private sale, he may accept any consideration—money or security—which he and the bondholders' committee may approve, he may sell any part or all of the collateral, he may act with the same freedom as any individual owner

Withdrawal and Substitution of Collateral

Two important covenants in the collateral trust indenture are those relating to the withdrawal of collateral for sale, and to the substitution of other collateral for that previously deposited with the trustee It is customary for the collateral trust indenture to provide that the corporation be entitled to withdraw from pledge under the trust indenture all or any part of the securities pledged. The withdrawal clause provides that the corporation may withdraw at any time any portion of the pledged securities, proportionate to the amount of any bonds which may have been retired, either by sinking fund or by purchase in the open market In other words, as the collateral secured debt itself is reduced, it is the privilege of the corporation to reduce the amount

of the collateral pledged, so long as it maintains the same ratio of collateral value to debt for the balance of the debt outstanding, as was previously pledged It is also a common provision of collateral trust indentures to permit the debtor corporation to sell any part or all of the collateral which has been pledged, provided that the collateral can be sold for a specified minimum cash price and that the cash avails of such sale are transferred immediately to the trustee The trustee then is required to retire any part or all of the collateral trust bonds outstanding, according to the amount of money which he has received from the sale.

Frequently, collateral trust indentures provide that the borrowing company shall be free to substitute new collateral for a part or all of the collateral previously pledged It is to the advantage of the borrowing corporation to have this privilege. If they can substitute different securities for those previously pledged, they are free to dispose of the original securities They can also pledge the original collateral, after it has been obtained by the process of substitution, for another loan, and by this means increase the flexibility of their corporate financing This is standard practice in collaterally secured borrowing from banks In the field of long-term finance, collateral trust indentures have merely carried over.

While substitution, from the standpoint of the corporation, is often desirable, and while, if the company's judgment in making the exchange is sound, its financial position may profit by substitution, the strictest precautions must be included in the collateral trust indenture to make sure that substitution does not lessen the value of the total collateral pledged. For example, the indenture of the Krueger and Toll Company collateral trust bonds allowed the substitution, for the original government bonds deposited, of any bonds of the same class and of equal par value whose interest was not in default, and the income from which, and the par value of which, was equal to 120 per cent of the par value of, and interest payable on, the collateral trust bonds outstanding In accordance with the provisions of this indenture, Krueger and Toll withdrew a large amount of high-grade bonds, including $13,000,000 of French government bonds, and substituted for them the stipulated par value—in all respects conforming to the requirements of the indenture—of bonds of Latvia, Hungary, Yugoslavia, Ecuador and other second- and third-rate government risks Shortly after, due to the impact

of the world depression and the difficulty of securing foreign exchange to service these bonds, these countries, whose bonds had been substituted, defaulted, reducing the value of the collateral to nominal figures, and causing immediate default in the interest of these Krueger and Toll bonds

A different plan was followed in drawing up the collateral trust indenture of the Alleghany Corporation, which issued collateral trust bonds in 1930. There it was stipulated, and the agreement was guaranteed by O P. and M J. Van Sweringen, who controlled the Alleghany Corporation, that at least 150 per cent of the par value of the bonds outstanding, measured by the *market* value of the collateral, would be at all times maintained in the hands of the trustee There were also penalties attached to failure to maintain this margin of collateral, namely, that the Alleghany Corporation could pay no dividends on any class of its stock, that the voting power on the stock should pass to the trustee of the indenture, and that the income on the securities deposited should be impounded by the trustee for the benefit of the holders of these collateral trust bonds Under this indenture, the Alleghany Corporation was forced to suspend dividends, or the Van Sweringens were forced to personally provide, from time to time during 1931 and 1932, additional collateral to maintain the 150 per cent guarantee. When their resources in collateral were exhausted, the provisions of the indenture were duly carried out They lost control of the Alleghany Corporation, and the income from the collateral was held by the Guaranty Trust Company, as trustee.

In the case of Krueger and Toll, due to the ignorance, carelessness, or optimism of those concerned in drawing up the indenture, Ivor Krueger, who administered Krueger and Toll, was able, acting directly within the permissive requirements of the indenture, by withdrawing good securities and substituting weak securities, to destroy the value of the collateral trust bonds With the Alleghany Company collateral trust bonds, however, because of the care and conservatism shown by the bankers who marketed these securities, the entire income of the borrowing company was secured for the bondholders at the expense of the preferred stockholders of the Alleghany Corporation, and this income has been sufficient, throughout the depression, to meet most of the interest on these collateral trust bonds.

While provisions similar to the above give the maximum available

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While provisions similar to the above give the maximum available

protection to the bondholders against deterioration of their security, it should be remembered that market value is not a perfect standard by which to determine the value of collateral. Bonds of the same company are in all cases inherently better from the standpoint of security than the stock, because of the prior position of bondholders as claimants to income If the investor measures the value of securities by the amount which can be realized in liquidation, however, even though his collateral may consist of sound bonds whose interest will be paid in good times and in bad, he can not count on realizing at any given time the full market value of these bonds In a thin market, where, for example, the insurance companies have withdrawn their bids, and where banks are conserving their resources, it will usually be found impossible to market any large quantity of bonds All that the trustee can do when he takes formal possession of the collateral is to hold the bonds for a better market, and then peddle them out in small lots over an extended period of time.

CHAPTER 12

CORPORATION DEBT SECURED BY OTHER FORMS OF PERSONAL PROPERTY

Security for corporate obligations is usually furnished by real property in the form of plant, or personal property in the form of stocks and bonds. Suppose now that the management wishes to go further in their borrowing, and pledge forms of personal property, other than stocks and bonds, necessary to the business and, at the same time, to retain the use of this property. How can this be accomplished?

Chattel Mortgage

As a class, personal property of this kind is known as chattels, and the instrument used to pledge such property as security for a loan is the chattel mortgage Under its provisions, the title to a block of merchandise, or a number of cattle or hogs, or a fleet of motor-trucks is conveyed to a trustee, as security for a loan, while the possession of the property remains with the borrower. The borrower agrees that the goods or machinery pledged shall be held as the property of the lender and, when sold, that the proceeds shall be paid to the lender. Failing payment of principal or interest, it is agreed the lender shall take possession of the property pledged as security by the usual legal process, and have it sold to satisfy the debt.

The chattel mortgage is not a desirable form of security. Physical possession of the property pledged and the *apparent* title remain in the borrower who may convert the proceeds obtained from a sale of the property to his own use His other creditors, not having legally sufficient knowledge of the existence of the prior lien of the chattel mortgage, may obtain possession of the property pledged as security To overcome these objections, various plans have been devised, notably in Pennsylvania, where the laws make no provision for the recording of chattel mortgages, except on personal property in the forms of coal, logs, pig-iron, and cattle, by which companies may borrow on the security of personal property with safety to the lender.

Of these methods the following will be described

1. The car trust loan issued under the Philadelphia plan.
2. Loans on contracts of purchase and sale.
3. The assignment of a lease by a subsidiary company as security
4. The leasehold as security for bonds
5. Loans on the security of merchandise and accounts receivable.

Bonds Secured by Assignment of a Lease

The lease is used by railroad companies to borrow money for the purchase of equipment securing an obligation known as the car trust certificate By this method, property acquired serves as security for the bonds and they are also the direct obligation of the railroad company. This method of borrowing may be illustrated by the issue of the Lehigh Valley Car Trust Certificates, Series G. A syndicate, headed by E T Stotesbury, a leading Philadelphia banker, was organized to purchase and pay for a large number of passenger and freight cars. E. T. Stotesbury then executed an agreement whereby, in return for certain payments and on the basis of certain covenants and stipulations, he leased to the railroad company the equipment which he had purchased, and which is carefully enumerated and described. The Lehigh Valley Railroad Company, for its part, in return for being allowed the use of the cars, agreed to pay $203,398 80 before the equipment was delivered to them and half-yearly the following sums first, a sum equal to 4½ per cent on $800,000, to be reduced from time to time by 4½ per cent on money paid by the railroad company in reduction of $800,000; second, a sum equal to all expenses incurred by the lessor in enforcing the terms and covenants of the lease, third, a sum equal to the taxes which the lessor might be liable to pay, fourth, the sum of $100,000 yearly, making in all eight annual payments of $100,000 each.

The eight annual payments of $100,000 to be made were evidenced by certificates (notes), the substance of which is as follows

The Lehigh Valley Railroad Company hereby acknowledges itself to be indebted to the bearer, or registered owner hereof, in the sum of $1,000 with interest at the rate of 4½ per cent per annum. This certificate is one

of a series of 800 for $1,000 each issued under the terms of a lease between E T. Stotesbury and the Lehigh Valley Railroad Company.[1]

Additional Covenants of the Lessor

In addition to its agreement to make the payments, the railroad company agrees to keep and maintain the equipment in good order and repair at its own expense, to replace any of the equipment which may be destroyed from any cause, to keep the equipment numbered and marked with the name of the lessor, to indemnify and protect the lessor and others in the use of any and all patented inventions employed in and about the equipment, to comply with all lawful requirements as to the use of air-brakes and other appliances with respect to the equipment, to furnish the lessor, at least once each calendar year, an accurate inventory of equipment in actual service, to allow the lessor or his assigns to inspect the equipment at the expense of the railroad company, not to assign or transfer its rights or interest in the equipment nor sublet any of the property without the consent of the lessor, and, in case of default under any of the provisions of the lease by the lessee, it may be declared terminated and the lessor may enter upon the premises of the lessee and retake the equipment and withdraw it from the railroad's premises The lessor on his part agrees that, when the lessee shall have fully paid all the rent agreed upon, he will upon the payment by the lessee railroad company of the additional sum of one dollar, transfer to the railroad company, as its absolute property, all the equipment held under the lease. The rental referred to in this agreement consists of three parts, first, a sum of cash which is usually considered to represent the expenses and profits of the syndicate which purchased the equipment, second, a sum which represents the purchase price of the equipment payable in instalments, and third, interest on the unpaid instalments of the purchase price.

The Lease as Security

The equipment having been purchased and leased to the Lehigh Valley Railroad Company, the purchaser-lessor assigns the lease agreement as security for the notes evidencing the deferred payments under the lease, to the Girard Trust Company, substantially as follows

[1] Only the essential portions of the Car Trust Certificate are given

First, that the said E. T. Stotesbury hereby assigns unto the Girard Trust Company as trustee for the holders of the certificates hereinafter set forth, all the right, title and interest of said E T Stotesbury in and to a certain indenture of lease bearing even date herewith made by the said E T Stotesbury to the Lehigh Valley Railroad Co

Second, the said trustee covenants and agrees that it will certify and deliver to Drexel and Co (for whom Stotesbury is acting) for distribution to the several subscribers to the said Lehigh Valley Car Trust Fund eight hundred certificates in the following form (given above) which certificates shall be delivered in amounts and at times corresponding to the value and time of delivery of the various lots of said railroad cars by the said E T. Stotesbury to the Lehigh Valley Railroad Company All of which certificates, when and as issued, shall be entitled to the security of all such railroad cars previously and subsequently delivered by said E T Stotesbury to the Railroad Company under the terms of said indenture of lease of even date herewith.

These certificates were numbered consecutively from one to eight hundred and were payable in eight annual instalments of $100,000

Covenants for the Protection of Certificate Holders

The agreement for assignment of lease, to which the Lehigh Valley Railroad Company is made a party, provides in detail for the protection of the holders of these notes by the trustee In case of any default in the payments under the lease, or the breach of any other covenant by the railroad company, the trustee is authorized to take possession of the equipment, and to hold, or lease, or otherwise dispose of all or any part of the equipment in such manner as he may deem beneficial, and also to recover from the company, for future accruing rent, any deficit which may remain after the sale or lease of the equipment and the application of the proceeds to the claims of the note holders.

Strong Position of Equipment Trust Obligations

From the foregoing, the strong position of equipment trust obligations is evident They are, in fact, bonds of the railroad, supplemented by the security of a lease of railway equipment, assigned to a trustee by the owner. They have the further advantage—since it is usual to issue them under the serial plan which provides that a specified amount of the principal shall mature semi-annually or annually until the entire amount is paid off—that their margin of safety constantly increases, since all the

equipment is security for the obligations outstanding, until such time as the last series matures. The last notes are paid, as a rule, while the equipment is still in service. Equipment trust obligations usually bear higher rates of interest than first-mortgage bonds issued for long terms. They also yield higher returns to the investor than first-mortgage bonds, while the security which they offer is practically perfect.

The Guaranty Trust Company of New York, in a circular pertaining to the advantages of the equipment trust securities, summarized these advantages as follows:

> The equipment of a railroad corporation is essential to its operation. It is the tool with which the railroad handles its business. If an individual mechanic becomes bankrupt, his tools are ordinarily exempt from seizure on the ground that possession of the tools is necessary for the mechanic to obtain his livelihood and ultimately satisfy his creditors. In the same way the courts, both state and federal, have ruled that the necessary equipment of a railroad must be preserved for the receiver of a bankrupt railroad in order to enable him to operate the railroad, and have generally placed the charges of principal and interest of equipment obligations upon an equality with charges for wages, materials, and other operating expenses, and in priority to interest, of, even, first mortgage bonds.

The record of equipment obligations secured by leases of equipment, issued by railroad companies which have subsequent to the issue of the obligations gone into bankruptcy, confirms this favorable judgment. With few exceptions, even by companies where all other bonds were reduced in interest rate or principal, the instalments of the principal and interest on equipment bonds have been paid in full. This strong position of equipment obligations in insolvency is due to the fact that their security is not the property of the insolvent corporation. The cars or locomotives, title to which has been pledged to secure the equipment obligations, are the property of another, who has leased them to the railroad company under certain definite conditions. Unless these conditions are met, the equipment can be hauled off the company's property and sold. Property which is owned by the company can be put out of reach of creditors and placed within the protection of the court. The court, however, can have no jurisdiction over property not belonging to the bankrupt corporation. The receiver or bankruptcy trustee, for the company or its property, no matter if he defaults on the first-mortgage

bonds of the company, must pay the interest and principal of the equipment trustee obligations, if the use of the equipment is to be retained. The equipment obligations even of bankrupt companies, with few exceptions, preserve a considerable amount of their original market value If earnings are made, so far as they suffice to pay the instalments on equipment trust certificates, the courts will order the interest to be paid

Loans on Contracts of Purchase and Sale

As a device to assure and secure a lender, the underwriting, or conditional purchase agreement, has a limited application in financing the purchase of property for resale It is standard practice with investment bankers, who have contracted to purchase an issue of bonds from a corporation seeking new capital and to pay the corporation the entire purchase price in cash within a few weeks, to borrow from commercial banks any money needed to meet their payments. As security for the bank loans, they may pledge, not only the bonds themselves—as yet not sold to the public—but in addition the contracts between the investment banker, who has obligated himself to the corporation, and other investment bankers who, as members of a syndicate, have agreed to take and dispose of the bonds by sale to the public Commercial banks must be careful in these matters They look not only to the immediate but to the ultimate value of the collateral for their loans, particularly where the bond issue is that of a new or unseasoned corporation. If it is necessary to sell the collateral, the bank may wish to find an immediate market and to know the price ruling in that market. If the bonds have fallen in price so that liquidation sale would produce less than the bank loans, the commercial banks have a fixed market in the assigned obligations of the members of the underwriting syndicate to take the bonds and pay cash With strong investment banking houses heading underwriting syndicates however, it is unusual to "hock" the underwriting agreements

Similar agreements have been entered into between corporations and commercial banks in financing the construction of ships and apartment houses, although the use of contracts of purchase as security in such instances is rare.

Corporations frequently purchase equipment under the conditional sale or "New York" plan By this method, title to the property desired

by the corporation is conveyed by the manufacturer to a trustee, and it is subsequently sold to a corporation for a down-payment and a series of notes. This sale is conditional in the sense that the title to the property remains with the trustee until all notes are paid. The trustee gives the notes and the down-payment to the manufacturer in full payment for the equipment These notes, usually in negotiable form, are converted into cash by the manufacturer by selling them to an investment banker, who afterwards sells them to the public.

The conditional sale plan does not give equal security with the lease since with the lease there is no title passing From the standpoint of the general unsecured creditors of the borrowing corporation, the conditional sale plan is superior to the method of financing by means of a lease, which lease is pledged to secure the obligation With the lease plan, the corporation has no title to the equipment, except the title of the lessee, until the entire amount of the obligation is paid In bankruptcy proceedings, the owners of the equipment, even though only a small amount of the rentals remain unpaid, may regain possession of the entire property With the conditional sale agreement, however, the borrower, now bankrupt, is liable only for the balance remaining If the property is sold by the trustee in bankruptcy, after the balance is paid, any surplus remaining goes into the general fund available for the payment of all creditors.

Use of the Lease by a Subsidiary Company as Security

The equipment trust certificate represents the most familiar use of the lease as a means of obtaining capital funds Another method often employed is to organize a subsidiary company in the interest of a company desiring to obtain capital funds This subsidiary company constructs or purchases the equipment or other property needed by the parent company, issuing for the purpose its own first-mortgage bonds which may be guaranteed by the parent company The acquired property is then leased to the parent company for a rental sufficient to pay the interest on the bonds and to retire their principal after a term of years In some cases, the rental is made sufficient to pay dividends on the stock of the subsidiary company. After the bonds of the subsidiary company have been retired, the property, upon the payment of a nominal sum, passes to the parent company For the greater protection of bondholders, it is customary for the subsidiary company, in such a case, to

assign to the trustee the lease out of whose rentals the money to pay the interest on the bond must come If the rental is not paid, then the interest can not be paid The bonds are in default, and their holders can bring foreclosure proceedings The trustee can then sue the lessee-parent company either upon its obligation as guarantor, in case it has endorsed the bonds of the subsidiary company, or under its contract of lease.

The Leasehold a Security for Bonds

A third use of the lease as security is by the lessee company. The lease, being a contract for the use of certain property on the payment of certain sums as rentals, often produces a surplus to the lessee over the amount of the rentals This surplus makes the leasehold interest—the present worth of the annual profits of the lease—a valuable right which can be pledged by the lessee, like any other thing of value, as security for bonds.

Illustration of Bond Secured by Leasehold

In recent years in long-term financing and when the margin of earnings over rentals were large, the lessee company capitalized on the basis of its leasehold interest, treating the rentals under the lease as a fixed charge and capitalizing the profits as a sum of value on which bonds and stock were issued. To illustrate, let us assume that Corporation A (the owner) leases a valuable central city business site to Corporation B (the tenant) for a period of 99 years at a fixed rental or a predetermined scale of rentals. Corporation B, in turn, sub-lets the premises to Corporation C (the subtenant) for 99 years, the subtenant intending to build and operate a hotel or apartment house upon the site The rental to be paid to the tenant by the subtenant is substantially in excess of the rental paid by the tenant to the owner, the excess amounting to $1,000,000 a year If the plans reach fruition and the hotel is profitably operated, so that the subtenant earns a comfortable margin over his rental obligation, the tenant has $1,000,000 of annual income, known as a leasehold interest which can be used as security for an issue of his bonds. Assuming that corporate operating expenses of the tenant amount to $200,000, he has $800,000 of reasonably assured annual income to meet interest and amortization payments on the bonds Certainly the tenant should not issue bonds in such amount that their interest and sinking

fund payments encroach too closely upon the value of the leasehold interest If $350,000 for such a purpose could be considered safe, $150,000 to be applied to interest and $200,000 to sinking fund, then the tenant could issue $3,000,000 of 5 per cent bonds, which would be retired at the end of fifteen years.

Should the subtenant default in the payment of rental to the tenant, he is evicted, and the tenant will operate the hotel in order to protect his rental obligation to the owner and his obligations under the bond issue The hotel building erected on the land becomes a part of the real estate of the owner, Corporation A. When the leases expire, unless they are renewed, the subtenant is left without a plant to operate He should, therefore, arrange to amortize out of earnings his investment in the hotel, so that his capital will be preserved.

Inferiority of Leasehold Interest as Security for Loans

A leasehold interest is inferior to fee simple property as security for bonds The tenant has an estate, just as the owner has, but his estate is subject to many conditions. He must pay rentals, taxes, assessments, and all other charges in the lease He must carry out franchise obligations if his property is operated under a franchise. He must keep the property insured and in good repair If he neglects any of these duties, his lease may be declared in default. As for the owner, all he need do is to pay taxes and discharge franchise obligations. The bondholder secured by a leasehold, if he forecloses his mortgage, merely succeeds to a variety of obligations which perhaps the tenant bond debtor had difficulty in discharging. The bondholder, secured by a mortgage on property, becomes, on foreclosure, the outright owner of the property

An illustration of the dangers that often lurk concealed in leasehold property is furnished by the condemnation proceedings, terminated in 1927, against the Jefferson-Belle Isle Realty Company. This company owned and operated a bridge over the St. Clair River near Detroit The bridge was located on property leased for 99 years with the provision that the lease should be canceled if the property was condemned by the city. This condemnation took place, in fact, condemnation proceedings had been started before the bonds were sold, but the bankers who sold the bonds said that they had no knowledge of this fact, and the jury of award gave no recognition to the value of the lease. Such

complications as this sometimes make leasehold property undesirable as a basis for a bond issue.

The Revolving Fund

Personal property in the form of merchandise and accounts and bills receivable can also be made to serve as security for loans by placing them in possession of the lender's representative, in a revolving fund

A revolving fund is a sum of value whose total amount does not diminish, although its composition may be constantly changing In order to operate this device successfully, the property comprising the fund is transferred to a trustee. The property is then sold and the cash or obligations—the proceeds of the sale—are turned over to the trustee who delivers the property on the order of the buyer This cash is invested in new merchandise which is shipped in the name of the trustee and the collections are deposited with the trustee The trustee's object and duty is to maintain the fund intact, surrendering merchandise or cash only where accounts, cash, or merchandise are received to an equal or greater value with that which is delivered.

This method of borrowing is superior, from the standpoint of security, to the method of the chattel mortgage, because the trustee of the lender has at all times physical possession of the full amount of the security

Illustration of the Operation of the Revolving Fund

In 1902 the Lehigh Valley Coal Company desired to borrow $3,000,000 on the security of its stock of mined coal and its accounts and bills receivable, and to make the loan for a period of years A summary of the indenture by which this purpose was accomplished through the instrumentality of a trustee is as follows

1 Coal Company assigns to Trustee all mined and prepared anthracite coal or the proceeds thereof. Trustee to certify bonds to extent of 75 per cent of value of coal, etc , not exceeding $3,000,000.

2 If the Trustee shall doubt solvency of any coal purchasers other accounts shall be substituted by Coal Company

3 Coal Company may substitute for coal, accounts, etc , securities satisfactory to Trustee.

4 Coal Company may redeem at any interest period at 102½ and interest.

5 Coal Company appoints Trustee its exclusive Mercantile Agent for all anthracite coal

6 Coal Company shall make leases or assignments of leases of land on which coal is stored for Trustee

7. Coal Company shall immediately deliver to Trustee a full statement of coal, coal accounts, and cash.

8 Coal Company shall fix price for sale of coal

9. Trustee shall hold coal, accounts, and cash for security of bondholders to pay interest when due, and bonds at maturity.

10. Trustee shall sell coal at price fixed by Coal Company but not be responsible for such sales

11 Coal Company may demand and receive from Trustee cash proceeds of sales when remaining margin is sufficient

12. Trustee shall keep accounts and after deducting salaries and expenses pay balance to Coal Company.

13. Trustee may insure all coal.

14. All money and property of Coal Company in hands of Trustee—pledged to secure bonds.

15 Bonds at no time to exceed 75 per cent of amount of coal, coal accounts, and cash In case of default—Trustee to withhold cash, or Coal Company may redeem bonds by purchase, or by lot at 102½ and interest

16. Copies of daily reports rendered to Trustees shall be open to inspection of bondholders

17. Trustee assumes no liability except for distribution of moneys in his possession

18 When all bonds are paid trust shall terminate

Here is a true revolving fund. The trust company at all times held and actually owned ample security for the bonds, even to the extent of controlling the ground on which the coal was stored Through this reservoir of value flowed the entire income of the Coal Company. Out of it, but only when filled to the brim with security, overflowed a stream of cash into the treasury of the Coal Company. The bonds were perfectly secured because the Trustee had at all times sufficient money and convertible property to pay them in full. The Coal Company was in no way inconvenienced because it carried on its business as the agent of the trustee, and the holder of these bonds was perfectly protected

This method can be adopted when security issues, either bonds or

preferred stock, are for the express purpose of providing working capital By setting up a revolving fund such as described above, the bankers can make sure that the money will not be diverted from its express purpose and that the assets will always be liquid

There is a certain objection to the revolving fund If the notification plan is used, that is, if the debtors of the company setting up the fund are notified that their obligations are the property of a trustee, and that they are to make payments either directly to the trustee or to the company as agent for the trustee, this fact is quickly broadcast by the commercial agencies, and the company's credit is gone. Even if notification is not given, it is impossible to keep the fact secret. To set up a revolving fund, therefore, is to go on a cash basis On the other hand, failure to notify, unless special precautions are taken, may weaken the security of the fund, since subsequent creditors, pleading "no notice," might attempt, in the event of bankruptcy or receivership, to establish a lien upon the current assets With proper precautions and reasonably close contact between company and trustee, the danger that outside creditors will establish a claim to the fund is not serious

CHAPTER 13

CORPORATE INDORSEMENTS AND GUARANTEES

When a corporation, desiring to borrow by means of a bond issue, finds that the bonds to be sold will have to carry a higher interest rate than the company normally pays, it will endeavor to avoid this disadvantage The situation here indicated usually occurs when a corporation has issued all of the bonds permitted to be issued under its first mortgage. These bonds represent the best security that the company can offer. If additional funds are to be borrowed, the security to be used will thus be inferior. Corporations wish to guard against impairment of their credit standing, which might be indicated by a rise in their cost of borrowing, as well as to keep the cost of such loans as low as possible A method frequently used by corporations confronted by this situation is to use the indorsement or guarantee. The indorsement, or guarantee, of a bond issue supplements the security pledged by the issuer, or, in the case of debentures, its general credit, with the credit of another corporation or individual, the guarantor When a corporation lends its credit as indorser or guarantor, it is not performing a gratuitous service An act of this kind presupposes a close financial alliance between the parties to the transaction. In fact, the relationship is one analogous to that of parent and child, the guarantor being a corporation or individual controlling the company whose bonds are guaranteed.

Use of the Indorsement

The first method is to organize a subsidiary company in the interest of the company which desires to borrow money. This company issues to the parent company its bonds secured by a first lien on the property purchased or constructed, also secured by the indorsement of the parent company The parent company either sells the subsidiary company's bonds, unless compelled by the terms of its prior lien mortgages to deliver all bonds of subsidiaries to the trustees of these mortgages, or deposits them as collateral security for an issue of its own collateral trust bonds. A large amount of railway mileage and many public utility plants

have been built in this manner through subsidiary companies, either because the parent company was limited in its borrowing by the terms of its mortgages, or because the laws of the state where the new properties were to be located required ownership by a domestic company. This form of financing new construction is not so common as formerly.

The use of the indorsement is still general One of the most common uses of this method in recent years is the indorsement of bonds of terminal companies, by the various railway corporations which make use of the facilities thus provided A number of issues of bonds have also been made by companies secured by the indorsement of certain prominent and wealthy individuals or firms Illustrations of this use of individual credit to bolster up the credit of a new company are furnished by H H Rogers in his guarantee of the bonds of the Virginian Railway, and by Henry M. Flagler, on the strength of whose personal guarantee a large amount of notes was sold by the Florida East Coast Railway Company. William Randolph Hearst also indorsed the bonds of a publishing company which he controlled

A feature of these personal guarantees which may cause trouble is the liability of the estate of the guarantor in the event of his death. A man's estate is liable for all his debts, and distribution will be deferred until all debts "presently due" on which he is liable as guarantor, have matured With a bond maturing twenty years from the time of the guarantor's death, however, the probate court will not delay distribution for this long period In any case the court will have to decide, by considering the period of time yet to elapse before the bonds mature, whether the decedent guarantor's estate should be held intact or disbursed If a substantial period of time must pass after the guarantor's death before the bonds mature, such a guarantee is of value only during the life of the guarantor. It might be provided, however, that the guarantor's life could be insured for the amount of the bonds guaranteed, the insurance premiums to be paid by the company, and the face of the policy paid to the trustee of the bonds, or the guarantor could deposit collateral to secure his obligation, the collateral being released as the obligation was reduced

Another use of the guarantee is the sale of equipment notes given to such companies as the American Locomotive Company or the American Car and Foundry Company by weak railway companies, and which are sold with the indorsement of the equipment companies. Here we find an

exception to the usual parent and child relationship. However, there are strong financial reasons impelling the equipment manufacturer to assume the contingent liability of indorser The railroad is in the market for locomotives or cars. The equipment company is hungry for orders By assuming the liability, it receives orders for its product which it might otherwise lose.

Weak Guarantees

The guarantee of a corporate bond has the significance of an indorsement on a promissory note By indorsing a note, a person or corporation alike agrees that, in case the maker can not pay the note at maturity, the indorser will pay it This is, in effect, a guarantee of the solvency of the maker It is weak in the sense that, should the maker not pay, two suits are necessary First, the creditors must by legal action establish the insolvency of the maker, and second, having done so, they may proceed against the guarantor. An example of a weak guarantee is as follows

> For value received the Great Western Power Company hereby guarantees to the holder of the within bond the prompt and punctual payment, according to the terms thereof, of the principal of, and interest upon, the within bond, and further guarantees to the said holder that the sinking fund instalments in respect to Series "A" bonds provided in the mortgage and deed of trust and in said bond referred to *shall be made in*[1] the manner and to the extent therein provided

It is clearly indicated in the wording of the above clause that the Great Western Power Company is merely guaranteeing the ability of the maker to discharge his debt obligation. This guarantee is weak in the sense that it stipulates that the holders of the bonds of the California Electric Generating Company to which the guarantee referred will receive their interest and principal and will be protected in accordance with the terms of the mortgage. The Great Western Power Company does not itself formally assume the obligation, but merely agrees to assume it in case the California Electric Generating Company, which issues the bonds, can not carry out its agreement

[1] Italics the authors'

Strong Guarantees

An example of a strong guarantee is as follows

For value received the St. Louis Southwestern Railway Company hereby unconditionally guarantees to the owner of the within bond the payment of the principal thereof and the interest thereon as the same matures and falls due, and hereby agrees itself to pay the said principal and interest if default in the payment thereof be made by the Terminal Company.

Here is an unconditional guarantee of debt by the guarantor, and this form is preferred to that first given This guarantee is strong because the guarantor, in effect, says to every purchaser of one of the bonds "I will pay if the maker does not pay" This is the equivalent of a suretyship and its greater strength lies in the fact that, default having occurred by the maker, only one suit is involved Legal action may be brought against the guarantor, immediately upon default, or more commonly, against the guarantor and the maker as joint defendants An even stronger form is the following guarantee indorsed upon bonds of the New York and Westchester Lighting Company, a subsidiary of the Consolidated Gas Company of New York

For value received, the Consolidated Gas Company of New York hereby assumes and agrees to pay the principal and interest of the within bond as the same shall respectively become payable

Here is the strongest form of guarantee, the assumption by the guarantor of the obligation of paying interest and principal, assuming the risk of reimbursement from the treasury of the subsidiary company [2] When this is done the transaction is not really one of guarantee, which is a contingent liability, but is equivalent to the creation of a direct debt obligation on the part of the guarantor.

Another form of guarantee provides that the guarantor shall deposit within a certain time before each interest date, with the trustee of the bonds, the amount required for the payment of that instalment of interest. As a rule, that form of guarantee is preferred in which the guarantor assumes an unconditional obligation Another common form of guaranteed security is stock on which a certain rate of dividend has

[2] These bonds are sometimes styled *assumed bonds* They are direct and unconditional obligations of the guarantor

been guaranteed by another company. This method is mainly employed in connection with leases, the guaranteed dividend representing the rental payment. Guaranteed stock, when the guarantor is a strong corporation, is very highly regarded by investors.

Joint Guarantees

Joint guarantees are similar in effect to joint indorsements. Each guarantor takes a definite amount of responsibility for the payment of the bonds. This form of guarantee is frequently used in connection with joint use of railway terminals. Here each company indicates the precise amount of the terminal company bonds for which it will be liable. Where there are a number of guarantors or indorsers on the same bonds without stipulation as to the amount assumed by each, we have a "joint and several" guarantee under which any one or more of the guarantors may be held liable, in the event of default, for the entire debt. Naturally, suit in such a case will be brought against the guarantor with the greatest financial strength, and he, in turn, would have to seek reimbursement from his co-guarantors. This is the method employed in recovering from indorsers on a promissory note. The holder of the note can sue any or all of the indorsers, leaving the indorser who pays to recover from his co-indorsers in the order in which their names appear.

Indirect Guarantees

A corporation, under the terms of a particular covenant in its mortgage, is often prohibited from assuming any contingent liability as guarantor or indorser on the bonds of another corporation. Or again, even though permitted to do so, it may have reached the limit of such contingent liability permitted. Restrictive covenants of this kind are avoided by means of a traffic or purchase or rental contract, entered into by the parent and subsidiary, by which the parent agrees to purchase a sufficient quantity of the subsidiary's product for a period of years, at a price sufficient to provide an amount of revenue each year for the subsidiary, which will be equal to or greater than the interest and sinking fund charges upon its bond issue. For example, an oil-refining company, prohibited by the terms of its mortgage from guaranteeing the bonds of an oil- or gas-producing company whose stock it owns, may accomplish the same result by entering into a contract with its stock-controlled company to buy from it an amount of oil or gas at a price high enough to

provide for the payment of interest on the bonds In such a case, while the company may be prohibited from guaranteeing obligations of other companies, it is not prohibited from making traffic or purchase agreements with such companies, and the obligations of the agreement are the same as the obligation of the guarantor This contract can then, if desired, be assigned to the trustee for the bondholders When so assigned, the trustee can proceed under the contract exactly as it would sue under a contract of indorsement in the event of default upon the subsidiary company bonds. Rental contracts for one or more floors in an office building may be made in the face of an agreement not to guarantee, and this rental contract may then be assigned to the trustee of a bond issue made by the owner of the building The obligation of the guarantor here is not to pay the interest on the bonds in case the issuer does not pay, but merely to pay his rent In case of default, the trustee for the bonds succeeds to the right of the former landlord.

In case of strong companies which have guaranteed bonds secured by mortgages on portions of their system, covering property which is essential to their business, guarantees are regarded as of great value Such bonds are often sold on no other security than the indorsement, no attention being paid to the earnings of the company actually issuing the bonds

Remedies against Guarantor

The remedy of the holders of guaranteed bonds or stock is the same as the remedy of the holder of an indorsed note, namely, a suit against the indorser for the amount remaining unpaid The objections to this form of security are, therefore, the ordinary objections to indorsement security The necessity, in some cases, of suing the indorser when there is a doubt in the indorser's mind as to his obligation under his guarantee, and the fact that where this method of providing a company with funds is adopted, there may be no limit to the amount of indorsement liability which may be assumed.

Dilution of Guarantee

The second objection to the guarantee mentioned above is more serious. When bonds are issued secured by a mortgage, certain property is conveyed to the trustee The purchaser of the bonds knows that, when the issue authorized by that mortgage has been exhausted, no further

bonds can be issued on that property, unless these are issued subject to the lien of the first mortgage He also knows the conditions under which bonds may be issued out of a bond reserve. The creditor knows what his security is On the other hand, a company with surplus earnings from all sources of $1,000,000 over interest charges, may place its indorsement on a series of bonds issued by other companies whose stock it has acquired, and whose dividends are taken into its own treasury. These guarantees, if the borrowing subsidiary companies do not prosper, may shrink in value, as the margin between the amount which the guarantor has agreed to pay under its indorsement, and its income from the stocks of its subsidiaries, is reduced The company with a surplus of $1,000,000 over its own fixed charges may assume the contingent liability of a guarantor up to $300,000 a year, and the bonds so guaranteed will be good entirely aside from the earning power of the companies which secure these bonds When, however, these guarantees aggregate $600,000 or $700,000 a year, the investor must look more closely into the condition of the borrowing companies and must place less reliance upon the security offered by the indorsement. An ample margin between the surplus earnings of the guarantor company over its own fixed charges and its contingent or direct liability for the debts of others, must be established if the value of the guaranteed bonds is to be maintained

This rule governing the security of a guarantee can be enforced by including in the indorsement an agreement of the guarantor to limit its contingent liability If, for example, its surplus earnings are $500,000 a year and it assumes a contingent liability to pay $250,000 a year, it may be provided in the indorsement that no additional guarantees will be made until the combined net earnings of the guarantor and of the company whose bonds are guaranteed for the preceding fiscal year, or for three or five years, are double the amount of its contingent liability as a guarantor By preserving a safe margin between the payments which may be required by the contingent liability, and the earnings out of which these payments must be made, the security of a guarantee may approach the security of a debenture.

Guaranteed Stock

Guaranteed stock ranks with guaranteed bonds and is valued in the same manner When the guarantor is strong, the stock will be valued for this reason If the earnings of the company issuing the stock are

adequate to protect the dividend rate guaranteed, the position is so much stronger Guaranteed stocks sell at high prices, reflecting the most favorable opinion of the investor A guarantee of stock refers to the payment of dividends only Stock has no maturity The redemption of stock at a stipulated annual rate by the issuing company can, of course, be guaranteed.

CHAPTER 14

THE SHORT-TERM NOTE

Corporations do not obtain all of their borrowed funds through the assumption of long-term debt Money is sometimes needed for only a short period. Capital requirements of this kind are usually financed by borrowing from commercial banks, a company note, either unsecured, or secured by the pledge of collateral, being used.

Normal Variation in Bond Interest Rates

Corporations frequently face the need for capital at a time when, due to extraordinary business activity, interest rates have risen substantially above normal. Every established corporation will have a credit rating If it is a sound company, it will expect to borrow, as occasion demands, at a cost which represents its credit status and likewise reflects the risk factor for its type of business In certain kinds of industry companies regularly issue bonds at lower interest rates than in others. For instance, the public utilities have, until recent years, been able to issue their bonds at lower interest rates than the industrials. This differentiation in interest cost has always been a reflection of investment favor, which is nothing more than a general classification of industries from a viewpoint of risk or stability of earnings No corporation wishes to be forced to borrow at a rate above that which custom has established for the industry in which it operates.

Reasons for Issuing Short-Term Notes

When business is booming and capital is scarce, the cost of borrowed money rises sharply, and corporations seeking loans at such times are forced to pay a higher price than they would customarily pay If the market rate of interest at the moment is 2 per cent above the customary rate of, say, 5 per cent and a corporation wishes to issue $10,000,000 of forty-year bonds, and assuming that none of the bonds will be retired before maturity, it will have to pay an additional cost of $8,000,000 (2 per cent on $10,000,000 for forty years), due solely

to the unfavorable condition of the money market when the bonds are issued.

To keep the additional cost as low as possible, there has been developed a special form of corporate obligation, known as the short-term note In form, the short-term note resembles a bond running for a period of one to five years and paying a higher rate of interest than long-term bonds of equal security.

This economy feature, which influences the sale of short-term notes, is no longer as important as it formerly was. Almost all bond issues now contain a callable feature, that is to say, the privilege reserved by the corporation to retire its debt in whole or in part, upon any semi-annual interest date after due notice has been given the bondholder, at a slight premium, 2½ per cent to 5 per cent. When the callable feature is included, even if a long term bond is sold on a 6 per cent basis when the normal market rate for such a company is 4 per cent or 4½ per cent, the loss incurred when a forty-year bond issue is sold at the higher interest, is not 40 times 2 per cent, but 2 per cent, times the number of years which elapse between the issue of the bonds and the date of their redemption. The improved credit of the corporation and the strength of the investment market enables it at once to call these high-interest bonds, and to replace them with 4 per cent or 4½ per cent obligations. But while the practice of issuing callable bonds restricts the use of high-interest short-term notes as an interim measure in long-term financing, the advantage of economy is still there, and furnishes an argument in favor of postponing long-term financing by the use of the short-term note device until an opportunity arises to dispose of a long-term issue by whose sale or exchange the short-term notes can be retired.

Another reason for the issue of short-term notes, which was more important a decade ago than that of immediate financial advantage, is the preference of the investment banker who acts as fiscal agent for the corporation issuing the notes. A corporation in need of money for additions to its plant approaches its bankers for advice as to the best means of raising this money The banker takes into consideration the condition of the money market. The time, in his opinion, is not opportune for a long-term issue. The national sky is cloudy. The attitude of the government is hostile. The investor is timid. Under these circumstances, the banker fears to undertake a commitment in long-term bonds which he might be unable to sell and which might be left on his hands

It is better to postpone long-term financing until a more favorable season. In the meantime, in the discharge of his duty as fiscal agent, he is prepared to buy an issue of short-term notes, secured or unsecured, which he can sell to the commercial banks, as well as to investment institutions. Commercial banks are always ready to buy, at attractive prices, an issue of short-term notes by a strong corporation, such as, for example, the Pennsylvania Company which has often resorted to this method.

The banker interested in the selection of short-term notes, of course, does not advertise another, and in many instances the controlling, reason. He makes two profits instead of one. He makes a small commission on the sale of the notes, and when the notes mature, if it is still considered unwise to take them up by an issue of long-term bonds, he makes another commission by securing an extension, or their replacement by another short-term note issue, and finally he makes a commission by the sale of a long-term issue when, ultimately, the notes are retired. It is well known that corporations seeking money have always to contend with this interested prejudice of the bankers in favor of double or triple profits which they secure from this form of financing.

Recent Experience with Short-Term Note Issues

The most recent illustration of the wholesale use of short-term notes was the period 1928 to 1931, inclusive The forepart of this period was characterized by wild speculation and an excessive demand for money with which this speculation was carried on Call-loan rates often ranged from 8 per cent to 20 per cent. In 1929, business corporations, attracted by the high rates of call money, had loaned over eight billion dollars in the New York money market, which was drawn from their working capital and placed at the disposal of market speculators. The bond market, at this time, was depressed, and the investor was mainly interested in stocks which were showing rapid appreciation in value. It was a very poor time for long-term bond financing. Corporations which were forced to raise money to expand their plants, in many cases, resorted to the issue of short-term notes.

During the year 1928 there were 179 issues of short-term notes sold, as reported in the Commercial and Financial Chronicle. These notes were issued by companies operating in a large variety of industries Among them were public utilities, oil, iron and steel, coal, copper, mortgage-

bond companies, investment trusts, hotels and clubs, land and realty companies, warehouse companies, foreign banks, finance companies, and the railroads These groups, at that time, enjoyed the strongest credit The total par value of the 179 issues was $278,968,200. It should be noted, however, that, in spite of the high rates of interest during 1928, other American corporations engaged in varied businesses issued a total of $3,911,000,000 total par value of long-term bonds.[1] This would indicate that most companies, even at this time, avoided the use of short-term notes, because of dangers inherent in their use, or sold their long-term bonds on an unfavorable basis, relying upon the callable feature in the bonds to enable them to refund the long-term bonds at lower rates of interest as soon as possible Some companies resorted to short-term note issues because of necessity, the pressure of investment banks for this (to them) more profitable form of financing

The use of the short-term note is also common during periods of business depression such as that which followed the panic of 1929. By 1931 the long-term capital market was almost closed If companies were forced to borrow, the only market was in the commercial banks, and the commercial banks would not take long-term bonds A substantial amount of short-term notes was therefore sold in 1930 and 1931.

Use of the Proceeds of Short-Term Note Issues

An analysis of the 179 note issues of 1928, with respect to the uses to which the proceeds were to be put, shows the same classification as that applying to long-term bonds issued in the same year. Listed according to their frequency, the purposes for which the proceeds were to be used were (1) Property acquisition, (2) Other corporate purposes (which might mean anything), (3) Working capital, (4) Refunding, (5) To retire indebtedness, (6) Improvements, (7) For expansion of business, and others of varied nature All of these purposes are those for which a business might require additional capital from time to time, and for the acquisition of which either bonds or stocks might be issued if the market were favorable. The use of short-term notes by these companies for the general run of corporate purposes would indicate that, for one or more of the reasons mentioned above, the other methods of financing were avoided.

[1] The figures on short-term notes are taken from an unpublished study by Richard P. Furman, Jr, Wharton School, 1935

Security for Short-Term Note Issues

Short-term notes are often secured Where the issuing corporation owns unencumbered property, it is common practice to secure the notes by a first mortgage If the property is not clear the short-term notes may be secured by a second lien or issued under a general or blanket mortgage. Fifty-nine of the 179 note issues of the year 1928 were mortgage notes of one kind or another, of which 44 were secured by first mortgage. The second largest group of secured notes, 31 in number, were collateral trust notes Here the property pledged consisted of stocks and bonds owned by the issuer A type of collateral security frequently used when the notes have been issued due to the immediate unsalability at attractive prices of mortgage bonds already authorized, is the long-term mortgage bonds themselves Here the issuer pledges as collateral the bonds which he expects to sell to retire the notes. It is usual to pledge additional collateral, if necessary to amply protect the notes Fifty-one of the 1928 note issues examined were debenture notes, no property of any kind was pledged to secure them Debenture notes are only available to corporations of the strongest credit standing, and eight of these issues were sold by public utility companies, which at that time were upon the crest of a wave of public investment favor. It is interesting to note in passing that 34 of the debenture issues were called gold notes, thus stressing the sales argument (since destroyed by our partial abandonment of the gold standard and the decisions of the United States Supreme Court) which was very common in this country prior to 1933.

Dangers Inherent in Short-Term Note Issue

That short-term note financing is not highly regarded by the people who have to pay these obligations, is convincingly shown by the relative amounts of short-term notes and long-term obligations put out during 1928 These figures have been already given. Suffice it to say here that the ratio of short-term notes to long-term bonds, in this year of large financing, was one to fifteen This was the year when the advantages of short-term note financing were conspicuous, but they were not sufficient to outweigh, in the minds of corporate managements, the dangers inherent in this type of financing Most corporations preferred, in their bond financing, to pay higher rates of interest, and to be safe This enor-

mous discrepancy in favor of long-term financing shows a general fear of the dangers in the issue of these short maturities.

Debt, as we shall show in greater detail in later chapters, is always a danger No matter how strong the issuing company may be, when the debt matures it must be paid, extended or exchanged for a new debt, and either of these courses of action may be inconvenient. With long-term financing, ample opportunity is given to a prosperous company to provide out of its earnings for the reduction or payment of its debt at maturity. In short-term financing, this resource is not available. If the company does not have cash resources sufficient to pay the debt at maturity, arrangements must be made to finance it And here the condition of the money market is of paramount importance. If interest rates are low and money is easy, no difficulty will be experienced. The investor will buy a long-term bond issue with the proceeds of which the short-term notes can be retired If, however, the financial outlook is dark and the investor discouraged by declines in the market values of his holdings, he is apathetic toward new issues. Then, the company seeking permanent financing must either pay high prices in its interest rates, or it must resort to the methods of extension or exchange, sacrificing some of the alleged advantages from the issue of these temporary obligations in the fees, expenses, and bonuses which the bankers exact

It is impossible, in this day of rapid change, to forecast the condition of the money market two or three years from a given date. The risk involved in short-term financing is too great for the slight advantages which it offers. If the proceeds of short-term financing were added to working capital, the danger of handling these notes at maturity is slight The same conditions that interfere with the issue of long-term bonds during depression usually reduce the need for working capital. As a rule, business declines during a period of depression The company using short-term financing to add to its working capital can, when the notes mature, reduce its working capital and use its surplus cash to pay off these obligations. If, on the other hand, the notes mature when business is still active and interest rates high, the company will have to face the difficulties already mentioned. As a rule, however, the proceeds of short-term notes, issued, as they are to anticipate permanent financing for additions to fixed capital, are invested in real property and equipment and not in inventories and accounts receivable And these additions to plant usually require a number of years before they can produce an

amount necessary to retire, or even substantially reduce, the notes issued to purchase and build them. The company has only its general credit, based on its earnings, to depend on when these notes mature. If they mature at a time when all business is depressed, those companies which have issued short-term obligations coming due at such an inopportune time often fall into serious difficulties because of their short-sighted policy in short-term borrowing

Of the 179 issues of short-term notes in 1928 already referred to, amounting to $278,000,000, the issuers of 33 (16 per cent), amounting to $43,000,000 par value defaulted on their notes. Seven issuers of $17,-250,000 short-term notes (6 per cent) were forced to extend, $191,-500,000 were either funded, retired at maturity, or retired before maturity. The amount of notes either extended or defaulted represented 22 per cent of the total amount issued, in other words, about one-fourth of the par value of the notes issued were in difficulty by the time of maturity. This is too high a percentage of failure to warrant even the most qualified approval of this method of financing. It is true that many of these companies could borrow in no other way than on short-term obligations, and it is also true, as we have pointed out, that the purchasers of these short-term notes often demand all the security in the way of mortgage or collateral which the borrower could furnish. In other words, the credit of many issuers of short-term notes during 1928 was too weak to support an issue of long-term bonds. All that can be said of such cases is that if they could not have borrowed safely, they should not have borrowed at all. The short-term borrowing which they resorted to, maturing during a period of intense depression, made their downfall even more certain than had they refused the illusory advantages of going into debt which the business situation of 1928 offered them

Debt should be incurred with great caution. It is, in our opinion, only justified under the most careful precautions and under the most blooming prospects of earnings available to pay interest and principal. Short-term notes, if the proceeds are to be invested in fixed capital, can be approved only in case of the strongest corporations whose obligations are secured by marketable collateral.

CHAPTER 15

PROVISION FOR THE REPAYMENT OF BONDS

The corporation bond is a promise to repay a sum borrowed It differs from a bank loan only in the fact that it matures in ten, twenty, or thirty years, instead of less than a year When a promissory note matures, it must be paid, either in money or by a new note. With short-term obligations, such as are given in exchange for bank loans, payment of a substantial part of the debt, if not all, is expected at maturity With corporation bonds, however, the custom with the principal borrowing companies, until recent years, has been to extend all or the greater part of the debt when it matures, exchanging new bonds for maturing bonds, keeping the security intact, and, if possible, increasing it. If any holder of a bond at its maturity demands cash for his obligation, the money is obtained by selling new bonds Bonds are frequently redeemable at any time upon the giving of notice, at a slight premium, at the option of the corporation, an essential feature in an expanding business where it is necessary to readjust the capital structure For example, old first-mortgage bonds may be retired to make room for a new issue of first mortgage bonds, whose security includes the security of the issue which is retired

Advantages of Refunding as Compared with Payment

The reasons for this practice of refunding instead of paying corporate debts lie in the relation of the bondholder to the corporation Bonds are sold to investors who wish to secure a return on their money and, if they desire, a return of their money when the bond matures. These investments are regarded as permanent The investor does not often desire the return of his money He wishes the continuance of interest payments and the security of principal If the principal of his bond is paid at maturity, he is obliged to look about for some other equally satisfactory investment, and this, at the time, may be hard to find Should the bondholder wish to convert his bonds into cash, if the interest has been regu-

larly paid and the margin of net earnings over bond interest has been increased, he can usually find a market for his bond at a price equal to or greater than the price he paid. When its bonds mature, it is not difficult for the corporation to offer a new issue to take the place of maturing bonds, secured by a first lien upon the same property. Those holders who desire to continue their investment may take the new bonds, while the money to pay those bonds whose holders want their money can be obtained by selling new bonds to new investors. While the conditions of security are met, the bondholder is indifferent to the payment of his principal. At maturity, or by sale before maturity if he desires, he can obtain his money. The bond investor is one who contributes capital to a company in return for a fixed and secured amount of its earnings. He asks of the corporation only that his income and the security of his principal shall be safe.

The full payment of bonds at maturity is also *apparently* opposed to the interest of the corporation. Provision for repayment is usually made by using a portion of the earnings in the periodical retirement of the debt, the company saving the interest on the bonds retired. The argument against accumulating a fund for the repayment of debt is similar to the argument for incurring the debt in the first place. If a company can make 10 per cent on new capital, it can safely and profitably sell bonds bearing 6 per cent interest. If, therefore, it is wise, in return for \$1,000 in hand, to incur an obligation to pay \$1,200 in interest—\$60 per year—on a twenty-year bond and also to agree to pay the principal at maturity, because 10 per cent or \$100 per year can be earned on the \$1,000, it is wise to invest \$50 per year in the business of the company on which a return of 10 per cent can be made, rather than to use this \$50 to retire the \$1,000 of debt over twenty years.

To put the matter in another way and disregarding compound interest, \$50 per year, taken out of profits and invested in new property at 10 per cent return, will produce \$950 in profits, and the original \$1,000 will still be intact in productive property, whereas, if the \$50 per year is spent in redeeming the debt, the savings in interest in twenty years will be only \$570, an apparent advantage of \$380 in favor of the method of extending rather than paying the debt. At the end of twenty years, if these profits are reinvested to yield 10 per cent, the original \$1,000, producing \$100 per year, will have increased to \$2,000, producing \$200 per year, or more than three times the interest charges on the \$1,000 of

debt, which can then be renewed or a new debt incurred to obtain the money to pay the original debt.

On the other hand, there is no assurance that the funds which would otherwise be appropriated to the sinking fund will be invested in improvements, yielding an average return of 10 per cent With a sinking fund, a certain positive gain is made each year—$50 saves $3 If invested in the business, $50 might make $5 a year, if the stockholders did not get the money in dividends, and if the expenditure was well planned, and if the company did not suffer some extraordinary loss The plan usually followed by well-managed companies whose business is permanent, is to recognize the strength of both arguments, improving the security and reducing the debt, and to make provision out of earnings to retire a certain amount, one-third or one-half of their bonds before maturity, leaving the rest to be refunded into bonds of a new issue

Types of Bonds Requiring Sinking Funds

Certain classes of business, moreover, require that bonds issued on the security of their property shall be paid before maturity The first class of companies which must maintain sinking funds are those whose bonds are secured by a mortgage on property which is exhausted by the operations of the business Railroad property, preserved and built up by adequate maintenance, may be supposed to last forever Hundred-year bonds, without sinking funds, have been issued on that assumption While, however, the physical assets may endure, their value, based on earnings, may disappear because of the competition of other forms of transportation In this sense, railroad bonds require sinking funds whose benefits the holders have not hitherto generally enjoyed

When, however, bonds are secured by a mortgage on seams of coal or on standing timber, or on land which is to be broken up into lots and sold, the security of the bonds is exhausted by the operations of the business. Every ton of coal mined and sold, every thousand feet of timber cut down and sent to market lessens by so much the security of the bonds which have been issued on this property. When bonds are issued by companies operating in such industries, special provision must be made out of earnings for paying the bonds, either by instalments or when they mature The company must preserve the relation between its debt and the security for that debt, either by reducing the amount of the debt as the value of the security falls, or by replacing the coal or

lumber sold with other property purchased out of its income, and there is no assurance that this can be done. Additional coal lands, for example, may not be available

The nature of sinking funds against bonds secured by so-called "wasting" assets is seen in the following statement of the sinking fund of bonds offered by a lumber company

> The mortgage requires the deposit with the trustee of $5 per 1,000 feet, mill run, on all timber cut It also requires the company to cut and manufacture exclusively from 15,920 acres containing 146,000,000 feet of timber, holding the remaining 38,000 acres, containing 232,000,000 feet, as a reserve, which cannot be cut during the life of this mortgage This sinking fund should retire over $500,000 of this loan before maturity, the unpaid balance of $300,000 will then have for security the remaining 38,000 acres

Similar plans for keeping up the sinking fund are usually followed by all companies of this character A coal-mining company will set aside 3 or 5 cents for each ton mined to make good the loss in its coal A land company will make certain payments to the trustee for each acre sold, or it may be required that a certain amount of the profits of a company shall be used to retire its debt A provision sometimes met with in sinking funds based on production, is a guaranteed minimum, so that the reduction of debt at some rate shall not be interrupted by a complete suspension of operations.

Sinking funds are also needful when bonds are issued by companies whose business is not plainly of an enduring character Railway bonds issued before the first World War usually carry no sinking funds, although later issues usually have this protection A letter from F J Lisman to J E Eastman, Chairman of the Interstate Commerce Commission, states the case in favor of railroad bond sinking funds as follows

> If it is good business for Smith, Brown, Jones and Robinson, each to pay their debts, it is good business for them and for all of us to do so, if engaged in business in a corporate form
>
> I am enclosing copy of a sinking fund schedule, from which you will note that if a company pays ¼ of 1% annually for a cumulative sinking fund, this will retire an entire 5% bond issue at par in 66½ years. Similarly, a 6% bond issue will be retired in 55¼ years
>
> As human affairs go, 62½ years, or 2½ generations, is a long while, and no one knows whether a thing that is considered absolutely permanent today will be in existence at that time

The bonds secured by companies operating interurban electric lines usually carried sinking funds, which have served in many cases, with the wholesale collapse of these companies in recent years, to lessen the losses of the bondholders Power companies, real estate, shipping and manufacturing, and trading companies can offer to the investor no certain assurance that twenty years from the time he buys their bonds, the original value of the property securing his bonds will be intact, and that the business will be prosperous. Such companies, in order to sell their bonds, must provide for payments to a trustee, from their annual earnings, of an amount sufficient to pay all or the greater part of their mortgage debts at maturity.

Types of Sinking Funds

Sinking funds are divided into two classes (1) where the company makes annual payments of either cash or of bonds purchased at less than par to a trustee, and (2) where bonds are issued under the serial plan so that a part of the principal matures each year until the entire amount is repaid within the term named

Disposition of Sinking Fund Payments

When the first plan is adopted, the question arises, what shall the trustee do with the money which is paid to him? Several methods of disposing of these funds are available The mortgage may provide that a certain number of bonds may be drawn by lot for retirement at a fixed price, notice being given by advertisement of the bonds so drawn, or provision may be made that an annual cash sinking fund of, say, 2½ per cent of the original issue, or of the amount outstanding, shall be paid to the trustee and shall be applied to the purchase and cancellation of these bonds at a price not exceeding, say, 105, or, if not to be had at this price, redeemed by lot at this price In some cases, also, the bonds purchased for the sinking fund are kept alive by the trustee uncanceled, and the interest on these bonds is added to the amount set aside for bond purchases for the sinking fund, so that the rate of debt reduction increases each year by a fixed amount Bonds can be deposited with the trustee at par value in lieu of cash payments When bonds can be purchased below par, the sinking fund burden to the extent of the discount, is reduced.

The method of drawing bonds by lot for retirement at a fixed price

is objectionable to the investor. He must be on the lookout for the numbers of the bonds advertised for retirement He is frequently put to some trouble in finding another satisfactory investment for the money which the corporation may at any time return to him These drawings of bonds, however, are usually for payment at a good premium over par value, and this premium is supposed to offset any trouble to which the investor may be put because a part of his bonds are paid off before maturity.

The plan of purchasing bonds in the open market is, from the investor's standpoint, better than the method of drawing bonds The bond market is less active than the stock market. Bonds are usually bought for permanent investment. Compared with stock sales, bonds come on the market less often and in smaller amounts The taking of this small floating supply by the sinking fund trustee, operates to maintain a market price higher than could be had without such a regular demand. From the standpoint of the corporation, however, aside from the fact that the buyers of these bonds are apt to be well satisfied with their investment and open to new offerings of the same kind, if the company must retire a certain par value of the bonds in each year by purchasing at the market price, it may sometimes suffer a loss because of the artificially high price resulting from the trustee's purchases

This objection is met by provisions similar to those given above, whereby the trustee is obliged to spend \$200,000 or \$300,000 each year in the purchase of bonds in the open market if these can be had at or below a certain price, say 105 or 106 per cent of par. If enough bonds are not forthcoming at this price, the trustee may draw a sufficient number of bonds by lot at the price stated to consume the money in the sinking fund This provision tends to keep down the market price to the figure at which the bonds can be drawn by the trustee for compulsory retirement.

A second alternative might be offered to the trustee in case he was not able to buy bonds at the price named in the mortgage He might be allowed to buy other securities with the money in the sinking fund. Some of the old Burlington mortgages contained this provision. This method, however, brings into the sinking fund an element of chance The bonds bought for the sinking fund may rise in price, in which case the security of the bondholders will improve, or their price may fall, and the objects of the sinking fund, to the amount of the decline, will

not be achieved If bonds are bought at par for the sinking fund, to offset a debt when it comes due, and if, in the meantime, the price of the bonds falls to 95, the sinking fund lacks 5 per cent of the sum needed to pay the bonds It is better, if any bonds are to be bought for the sinking fund, that they should be the bonds of the company which is retiring the debt, so that the reduction of its debt may be certain.

Another method of using money is to invest the fund in improvements and additions. This may be provided either unconditionally at the option of the corporation, or, in case bonds can not be purchased at a certain price for the sinking fund, as a substitute for the compulsory retirement by drawing bond numbers, the money may be invested in improvements. This investment of sinking fund money in property is, however, unusual because it does not certainly reduce the debt (the grand object of all sinking funds) Because the return on these investments is to some extent doubtful, it is not favored. A variant of this method of investing sinking fund money in the business is to use the unexpended balances of the sinking fund as working capital for the company, the trustee lending the money on good security—for example, trade acceptances or notes received for merchandise sold by the company—and in this manner having at all times the amount of the sinking fund in liquid form.

Disposal of Bonds Bought for the Sinking Fund

The methods of disposing of bonds bought by the trustee for the sinking fund are as follows (1) they may be canceled as purchased and delivered by the trustee to the company—the usual plan; (2) they may be kept alive in the sinking fund as an addition to the regular sinking fund appropriations. In this case the retirement of the bonds proceeds at an increasing rate because of the addition of the interest to the regular appropriations from income, (3) the bonds held in the sinking fund may be resold for the benefit of the company, the proceeds being invested in productive property as when they were originally issued. This provision converts the bonds held in the sinking fund into a bond reserve.

The Serial Plan of Bond Issue

The serial plan of bond issue is illustrated by the following offering of the 7 per cent bonds of the Monsanto Chemical Works, issued March

1, 1920. All of the twenty series were sold on the issue date at the following prices

MATURITY DATE AND SELLING PRICE OF EACH SERIES

$100,000 due Mar. 1, 1921,	at 99 76
100,000 due Sept 1, 1921,	at 99 65
100,000 due Mar. 1, 1922,	at 99 54
100,000 due Sept. 1, 1922,	at 99 44
100,000 due Mar. 1, 1923,	at 99 34
100,000 due Sept. 1, 1923,	at 99.24
100,000 due Mar. 1, 1924,	at 99.15
100,000 due Sept. 1, 1924,	at 99 05
100,000 due Mar. 1, 1925,	at 98 97
100,000 due Sept 1, 1925,	at 98 88
100,000 due Mar 1, 1926,	at 98 80
100,000 due Sept 1, 1926,	at 98.72
100,000 due Mar. 1, 1927,	at 98.65
100,000 due Sept. 1, 1927,	at 98.57
100,000 due Mar. 1, 1928,	at 98 50
100,000 due Sept. 1, 1928,	at 98 43
100,000 due Mar. 1, 1929,	at 98 37
100,000 due Sept. 1, 1929,	at 98 30
100,000 due Mar. 1, 1930,	at 98 24
100,000 due Sept. 1, 1930,	at 98 18

These bonds were offered at prices which represent a uniform yield of 7¼ per cent for all maturities, the price falling for the later maturities in order to make up in profit on redemption price, the difference between 7 per cent and 7¼ per cent yield

These bonds offer important advantages from the selling standpoint The earlier maturities are usually sold to banks, while the longer maturities appeal to the longer term investor, individual or institutional Banks and trust companies have always been large buyers of bonds, especially in recent years when commercial loans are scarce The purchase of long-term bonds with the money of depositors is, however, no better than a speculation. The prices of these promises to pay money at dates lying far in the future fluctuate according to the movement of prices, falling as they advance and rising as they decline

It is true that commercial banks need not sustain heavy losses from declines in bond values If the market goes against them they can get out of their holdings at small sacrifices, and when bond prices are advancing they often make fine profits [1] All this, however, is not banking but trading It involves the taking of unnecessary risks and is adopted with great caution by well-managed banking institutions On the other hand, the banker may be unable to lend his funds to his depositors or to purchase satisfactory commercial paper He is forced to buy some form of corporate obligation Short maturity serial bonds are suited to his requirements They promise to pay a definite sum within one or two years, and their security, which is a lien on real property or collateral, is, generally speaking, superior to that of the commercial paper with which they compete Banks are also large buyers of long-term bonds as they approach the date of maturity and pass, therefore, into the class of short-term obligations. A fifty-year bond, for example, which matures on January 1, 1941, on June 30, 1940, becomes a six months' note A special service is maintained to advise bankers of these early maturities

Serial bonds may be coupled with other forms of sinking funds. For example, when issued by a coal company, it is usual to provide for the payment of a fixed sum per ton of coal shipped into the hands of the trustee of the mortgage securing the serials If the sum so accumulated between serial payment dates exceeds the amount of the next payment, the surplus can be held by the trustee against subsequent payments If the current accumulations on a tonnage basis are insufficient, the company must find the money elsewhere It is also not unusual to find a certain percentage of the net earnings of a company paid to the trustee of a serial bond mortgage If the company is exceptionally fortunate, its obligations may, by this method, be provided for in advance of their maturity.

The serial bond plan is that of an exaggerated sinking fund It is a radical departure from the method, formerly universal, of making no provision for the payment of debt, relying on the value of the property

[1] Until the passage of the MacFadden Bill in 1926, national banks could invest in bonds only by a subterfuge The National Banking Law allowed them to buy promissory notes A corporation bond is a promissory note, but it is not the kind of promissory note that the framers of the National Bank Act had in mind The MacFadden Bill expressly authorize national banks to purchase investment bonds under regulations to be made and changed from time to time by the Comptroller of the Currency

and its growing earnings to furnish a basis for a new bond issue to take the place of the old. Under the serial plan, the entire bond issue will be paid at definite dates if the company remains solvent. The principal of the debt steadily and rapidly diminishes. The security either remains the same, or, if it depreciates, as for example, when bonds are issued on the security of railway equipment or automobiles which wear out with use or age, will depreciate at a lower rate than the rate of the debt payment.

There is no way for the corporation which has borrowed on the serial plan to postpone or evade its obligations. Every year $100,000, or $250,000 or $500,000 must be found, in addition to the interest. With a sinking fund based on business done—tonnage extracted or timber shipped—or a sinking fund based on net earnings, there is some measure of latitude for the company. When business is dull, sinking fund payments may be reduced by obtaining the consent of the bondholders. With the serial plan, however, there is no respite. Each year brings its instalment. It is sometimes extremely inconvenient to make these payments. Because of the urgent necessity of finding the money, even forced sales of inventory or bonuses for loans may be necessary. The imminence of these short maturities also operates to limit closely a company's credit. Its bonds consist of a succession of annual or semi-annual instalments of bills payable. The banker to whom a company in this situation applies for a commercial loan will be very cautious and will probably demand special security.

On the other hand, the company which has borrowed to the limit of its resources on the serial plan has set its feet on the path that leads to solvency and prosperity. It has been said that the payment of debt should be "persistent, anxious, and increasing." These requirements are fully met by the serial plan. A company in such a position must manage its affairs with economy and caution. Capital expenditures must be carefully considered, and the wasteful expenditures in ill-considered experiments and too rapid expansion which often attend a large and unallotted cash balance will be few. The pressure of urgent necessity is constantly bearing upon the managers. They walk always in the shadow of apprehension, and are not likely to be taken unawares by some unforeseen development.

A further advance in sinking fund method is to assign certain revenues to the trustee of the mortgage to apply on interest and sinking fund payments. Such a plan might provide that the rental of a building which

secures a bond issue should be paid by the tenant (in case the entire building is rented to one tenant) to the trustee, to be applied to debt payment. This removes the possibility of default if the rentals are sufficient for interest and sinking fund payments, as long as the tenant remains solvent, and makes it impossible for the borrowing landlord to delay or divert sinking fund payments.

Conditional Sinking Funds

A qualification must be made to the argument in favor of high sinking funds. A sinking fund represents an unconditional promise to pay a substantial amount of the principal of a debt at a definite date. Some catastrophe, such as a financial panic, or a nation-wide strike, may make this payment impossible. Shall the company, normally solvent and able to meet every obligation, be forced into bankruptcy because of such an untoward event? The bondholders do not welcome such a catastrophe, which might put them overnight into business in order to get their money. Some relaxation of the rigid requirements of an unconditional promise to pay is demanded. Sinking funds are frequently arranged on a graduated ascending scale, e g , beginning two years after the date of issuing the bonds. Serial payments are often arranged on a small scale, at first, rising to the full amount necessary to extinguish the total debt at the end of a period. For example, a ten-year bond can be arranged to mature in nine instalments, the first due-date being two years from the date of issue. Sinking funds may also be made cumulative in whole or in part. Payments which it is impossible to make in lean years are carried over, accumulated, to the fat years. *For a limited* time the deferred payments cause the corporation no more embarrassment than that caused by failure to pay dividends on cumulative preferred stock.

In conclusion, there are no exceptions to the rule that when a debt is once incurred, provision should be made out of earnings for paying it at maturity. No matter what the security may be, no matter how much the company may need capital for expansion, no matter how alluring are the prospects of profits to be realized on the money which would otherwise go to the sinking fund, all these considerations sink into insignificance compared with the paramount consideration of safety and solvency. Safety and solvency can only be assured if debts are paid. The example of the municipal bond might be taken to heart by directors who have issued one-hundred-year bonds, with no specific provisions for repay-

ment In those states where conservative financial practice is enforced, a municipality, when it incurs a debt, simultaneously levies a tax to meet the debt, both principal and interest The justification for this practice is that municipal debts are incurred for property improvements, schoolhouses, sewers, bridges, street-paving, and the like Within a comparatively short time—ten years, or twenty years at the longest—these improvements are either worn out or have become obsolete, and sound financial practice demands that, during the life of the loan, provision should be made to pay it

Railway corporations, on the other hand, otherwise well managed, have arranged the terms of their debt on the presumption that a century from now the railroad, for example, will be hauling all of the heavy freight in the United States. They assume that power will be generated by the burning of coal and that coal will be hauled in long freight trains which produce from $3,000 to $5,000 of gross revenue from each trip They assume that the present distribution of population will be continued, that the great cities which have conditioned the present form of the railroad structure will still remain as they are to-day, that the supplies of raw materials will be the same and will come from the same sources They assume, in effect, a static economic structure. All experience shows that the economic structure is not static, but is exceedingly dynamic, that every part and feature of it is subject to constant change and obsolescence, that even the best informed forecasters of economic development can not project their vision beyond a short term of years

To give but one illustration The most profitable railway traffic is bituminous coal, as already indicated It is hauled in heavy trainloads at high speed and at high rates Without bituminous coal traffic, no railroad in the industrialized section of the country north of the Ohio and east of the Mississippi could meet its taxes, much less its interest charges.

Most of the large railroads still paying regular common stock dividends are bituminous-coal carriers Already, however, the consumption of bituminous coal in the United States, measuring from the peak of the World War period, has declined 25 per cent This has been due to a general improvement in the method of burning coal, which reduced the amount of coal necessary to produce a given amount of power. It has also been due to the development of other sources of power—water-power, power generated by oil, and by natural gas. These power sources which

compete with bituminous coal are developing much more rapidly than the latter, which, in fact, is shrinking It is also within the bounds of possibility that it may become cheaper to transmit power over a wire than to haul coal from 300 to 500 miles over the mountains. Alternative methods of transmitting coal, as, for example, through pipes, are also in the offing The location of manufacturing industries which at present requires the transportation of large amounts of coal for long distances is rapidly changing, and as it changes, the demand upon the coal industry and upon the railroads is being reduced. Already the railroads in another profitable field, the transportation of gasoline, have lost a large part of their traffic to the pipe-line and the truck.

The bounds of doubt and uncertainty, as related to the future of this most important source of railway traffic—the production of bituminous coal—are by no means exhausted Enough has been said, however, to show how dubious is the prospect that railway earnings from this principal source of traffic will remain, twenty years from now, at, or even near their present level These facts are well known to bankers and corporation directors, and yet, in the terms of their bond issues they have, generally speaking, ignored them In railroad bonds, and to a large extent in other classes of bonds as well, the term of the bond is seldom less than twenty years, and often, as already stated, runs to fifty and occasionally to one hundred years or more The bond list of the New York Stock Exchange is full of 1967, 1975, 1997 maturities, some of them holdovers from the pre-War period, and some of them issued even after 1929.

All this long-term financing, leaving company debts to be paid by the great-grandchildren of the men who incur them, is very bad. It has already led to many railroad defaults, and in the future it may lead to other defaults. The utility companies, which have been more modest in their bond financing than the railroads, have been riding the crest of a wave of an advancing demand, and so far have experienced no serious trouble. There is no assurance, however, that the technical set-up of the electric power industry will permanently continue, and in partial recognition of this fact, power bonds have been issued for much shorter terms and with much larger sinking funds than have railroad bonds

In our opinion, a bond maturing more than twenty years from date, and without provisions made in the indenture to pay off at least half of the bond within its life, is a bond issued on an unsound basis.

CHAPTER 16

CAPITALIZATION OF CORPORATIONS

In preparing the financial plan under which the money necessary for the new enterprise will be provided, we have to deal with two main types of financial material: stocks and bonds. In connection with bonds, we have the lease, which resembles bonds in that the payments under it are fixed by contract and collectible by legal process. The nature and classification of stock, the different types of bonds, and the provisions of the supplementary contracts of security entered into between the corporation borrower and the lender, together with the provisions of the lease, have been discussed. Every corporate financial structure is the result of a plan. The promoters of the corporation have in mind the amount of money needed to purchase fixed assets and to provide working capital, and they have also estimated the profit which they expect the business venture will produce. It is the promoter who acts in the capacity of an architect and builder, using those financial materials which will enable him to build a structure that will meet his requirements.

Common Stock Capitalization Is Basic

We now consider the conditions under which these different materials, single or in combination, are used in the preparation of the financial plan. Most corporations, aside from public utility companies and consolidations, start with an issue of common stock. As we shall see, bonds and preferred stock are frequently added in the later stages of the company's development, but at the start, common stock is the material almost invariably used. Furthermore, many of the largest and most prosperous corporations, no matter to what huge size they may grow, do not change their capital structures from the common stcok form with which they started. The following companies, many the largest in their respective lines of business, have outstanding nothing but common stock (1938).[1]

[1] Industrial Compendium, *Commercial and Financial Chronicle*, June, 1939

Company	Amount of Assets
*Allied Chemical and Dye Corp	$396,801,864
*Alpha Portland Cement Co	20,876,076
American Agricultural Chemical Co (Del.)	21,870,419
American Machine and Foundry Co.	17,910,863
American Stores Co	31,838,740
Borden Co	122,400,607
Briggs Manufacturing Co	41,727,090
Calumet and Hecla Consolidated Copper Co	36,882,361
Chrysler Corp	216,542,411
Columbian Carbon Co	30,769,503
Congoleum Nairn Co	30,369,100
Eaton Manufacturing Co	14,788,795
*General Electric Co	374,465,199
*Hawaiian Pineapple Co, Ltd.	23,448,414
Hazel Atlas Glass Co	22,130,656
Kennecott Copper Corp	342,768,309
Libby-Owens Ford Glass Co	45,027,176
*Lone Star Cement Corp	46,002,752
Mack Trucks, Inc	41,105,660
*Mid Continent Petroleum Corp	63,692,349
Morrell, John and Co	26,680,323
Nash-Kelvinator Corp	47,345,811
*Oliver Farm Equipment Co	20,810,368
Packard Motor Car Co.	49,752,711
Pacific Mills	38,525,280
*Penney, J C., Co.	85,715,935
Pullman, Inc	256,103,745
St. Joseph Lead Co.	30,708,548
Sears, Roebuck and Co	286,084,551
Shattuck, Frank G, Co	20,931,219
South Penn Oil Co.	38,986,133
Spencer-Kellogg and Sons, Inc	24,129,051
Standard Oil Co of California	605,137,556
Standard Oil Co of Indiana	724,663,142
Standard Oil Co of Kentucky	41,056,534
Stewart-Warner Corp	18,678,622
Texas Gulf Sulphur Co	61,097,347
Timken Roller Bearing Co	43,422,577
*United Carbon Co	31,149,371
Westinghouse Air Brake Co.	50,105,744
	$4,442,502,912

Here is a list of 40 of the largest American industrial corporations, with $4,442,502,912 of assets, which have no preferred stocks or bonds outstanding. Those marked have, at one time or another, used special or preferred stocks and bonds in an emergency, but once their circumstances permitted, these senior securities were retired As for the small and medium-sized corporations (those with total assets of $1,000,000 or less), of which 390,894 with aggregate assets of $40,276,-800,000 reported to the Commissioner of Internal Revenue in 1935, it is exceptional to find bonds in their capital structures.

The basic material of the capital structure in the United States is common stock Most corporations never issue any other form of security When preferred stock or bonds are used, it is due to special circumstances, as, for example, to give promoters in consolidation a profit, or used in financing public utilities with large fixed capital and well-established earnings, or to finance companies with large supplies of raw material such as lumber, iron ore and coal, and by shipping and real estate companies. The reasons for these exceptions to the general rule will be developed in Chapter 17

Factors Affecting the Program of Security Issue

In determining the type of securities to be issued, several questions have to be answered how much money is required by the new company—this has been answered in the original investigation—how is this money to be provided, by whom, and by the sale of what securities? If the new venture is to be privately financed, that is, financed by those who expect to make money out of its earnings, instead of by selling its stock, a simple form of capitalization will suffice Stock will be issued up to the amount thought to be necessary If the managers look to the future, they may provide a reserve in this stock, calling only a portion of the par value or subscription price, leaving the balance available to supply future capital needs subject to call at the discretion of the directors This method is frequently employed in England. In the United States this plan is seldom used, because of our prejudice against partly paid stock. Here, it is the custom with small private companies to start with common stock subscriptions, advance to preferred stock, and finish with some form of bond, as

their original ideas expand, or their underestimates of cost must be corrected.

When capital is to be obtained from the general public at the time the business is started, the procedure is different Various conditions may be present which will influence the amount and kind of securities to be offered.

1 *A Construction Proposition in an Established Industry* The new enterprise may be a construction proposition in some established and well-understood line of industry, railroads, coal, copper, oil, or textiles, in which (a) the stock or bonds may be sold, or (b) retained until a showing of earnings has been made, so that a better price may be obtained for such part of the securities as may be available for sale Here, the amount of stock and bonds issued will be based upon a conservative, that is, moderate, estimate of earnings The minimum amount of money is the cost of the plant, plus working capital, as shown by the promoters' investigation So much must be raised The amount of cash which can be obtained by the sale of these securities after the company is on its feet, firmly established as a going concern, will be much greater In anticipation of this happy event, the capitalization, that is, the number of shares of stock, plus bonds, if the financial plan includes bonds, may be fixed at an amount above the minimum requirements, the securities being paid for by methods which will be presently explained In this case, however, the bounds of conservatism are not intentionally passed. Those responsible for starting the enterprise expect to continue their connection. They are, by subscription, loans, or underwriting guaranties, interested in the success of the new company They expect their interest to be more than temporary. A conservative estimate of earnings is still the basis of capitalization. Dividend and interest requirements will be kept well within the limit of probable earnings The prospects for continuous dividends upon stock issued under these circumstances are good

An illustration of a capitalization plan approved by the Interstate Commerce Commission was the bond issue of the Seaboard-All-Florida Railway Company The application was approved on November 21, 1925 The proposed line extended from West Palm Beach, 100 miles to Florida City It traversed territory with a population of 162,171 The proposed line was to furnish trunk-line and cross-state service to

thirty-two communities which did not then receive such service from the Florida East Coast Railway The estimated cost of construction was \$8,500,000, and the net operating income for the first year estimated to be \$1,025,000, with cumulative increases of 10 per cent during each of the succeeding four years The Interstate Commerce Commission allowed itself to be misinformed as to the amount of earnings which could be made, and the company has long been in bankruptcy.

Another illustration of the basis of capitalizing a new enterprise operating in an established industry and under known conditions, is the Rio Grande Valley Gas Company. The prospectus was issued April, 1927 The capitalization of the company was as follows

		Charges
First mortgage 7 per cent bonds	\$3,500,000	\$245,000
7 per cent cumulative preferred stock	1,700,000	119,000
Common stock without par value, shares	265,000	———
		\$364,000

The promoters must justify charges and preferred dividends of \$364,000 per year They do this as follows, quoting from the prospectus "This rapidly growing territory with a population of 175,000, and an area of 1,500 square miles, is said to produce agricultural tonnage in excess of any equal area in the United States, and has also substantial industrial activities"

Uniform franchises without burdensome restrictions were granted. . . The company had an exclusive contract for a period of ten years with the Central Power and Light Company (an Insull Property), to supply fuel for that company's generating station at San Benito. Other long-term contracts were to be made to supply fuel to other large industrial consumers The company's gas supply was assured under definite contracts with representative producers These fields constituted, in the opinion of geologists, a dependable source of gas extending beyond the life of these bonds The following estimate of earnings was made by Ford, Bacon and Davis after a detailed survey of both domestic and industrial demand immediately available in the communities to be served·

	1st Year	3rd Year	5th Year
Gross Income	$836,800	$1,338,864	$1,631,066
Operating Expenses and local taxes	341,800	482,965	562,670
Net available for interest and depreciation	495,000	865,719	1,068,396

Here was an attempt to set up a conservative capitalization of a new company operating an established industry in a new territory The engineers, on the basis of wide experience in these investigations, are able to estimate both revenues and expenses with approximate accuracy. As a rule, they will err, if at all, on the side of understatement. In 1933, the Rio Grande Valley Gas Company was unable to meet interest and sinking fund charges on its bonds. This failure, however, was due to the collapse of the Insull Utilities empire, and the severity of the depression in the Southwest which could hardly have been forecast at the time of promotion The company was reorganized, interest on bonds was reduced from 7 per cent to 5 per cent, and the company has been fairly successful in recent years.

2 *A Flotation in a New Industry*. The new company may be a public flotation designed to exploit some new industrial opportunity where the standards of judgment are unformed The best illustration of such projects were the so-called industrial trusts or holding companies, which were floated in large numbers from 1898 to 1902, the United States Steel Corporation being the largest. Here the basis of capitalization was also anticipated earnings Since the information from which to make an informed estimate of earnings was lacking, and because the securities issued were to be quickly sold, first by underwriters, and second, by owners of properties taken into the consolidation, these estimates were liberal, often to the point of exaggeration. The United States Steel Corporation, for example, was formed with a capital stock of approximately $1,000,000,000 plus $300,000,000 of bonds The $300,000,000 of bonds, plus $510,000,000 of preferred stock, represented the appraised value of the assets of the steel companies entering the consolidation, plus new working capital The common stock of over $508,000,000 had no counterpart in tangible assets of the new corporation It represented the generously estimated increased earning capacity of the consolidation All of the common stock went to

the bankers and organizers of the consolidation and to the stockholders of the constituent companies. This was a combination of combinations, a "trust of trusts," bringing together under one ownership over 60 per cent of the steel-producing capacity of the United States. Nothing like it had been heard of And yet leading banking firms indorsed it, recommended its securities, and marketed large amounts of them, no doubt in the honest belief that they would pay dividends. In this case, due in part to the large profits of the War, after some early disappointments—common dividends were suspended during 1904 and 1905—expectations were realized. By 1906, the common stock, against which there was originally no corresponding value in the assets, became a consistent dividend payer, continuing payment until 1931. This was a public flotation, based largely on prospects, and the apparent limit of the capitalization was future earnings, their amount being based on *hypothesis and conjecture, with a strong infusion of hopeful anticipation*

It would be going too far to assert that the basis of capitalization in such cases is the maximum net return—in cash—to the promoters, bankers, and vendors, the amount of securities whose sale will produce the largest obtainable amount of money. Aside from the criminal branch of the security-selling fraternity, these men are honest and honorable—quite as honest and even more honorable, because of the confidential nature of their relations, than many reputable vendors of merchandise More concentrated exaggeration can be found, in the writers' opinion, in the advertising pages of one Sunday newspaper than in a year of bond and stock circulars issued by reputable houses. They are not in business to defraud the public. They believe in the merits of the securities which they offer, even if the business supporting those securities is speculative in character. But they take the seller's viewpoint, and they puff and overpraise their wares Their predictions frequently have been discredited by the outcome of enterprises which they promote, and their basis of capitalization is, in many cases, shown by subsequent developments to be excessive The standard set for the second class of companies is anticipated earnings, based not on the opinion of those who are to hold the securities, but of those who are to sell them and profit from their sale

Exploits of a character similar to the flotation of the Steel Trust are seldom met with in these latter days. The investment banking fra-

ternity is so numerous and influential, their assistance is so necessary in the marketing of securities to the investor, and the investor himself is so much better informed than ever before, that the wild schemes of the past generation, no matter how well sponsored, could have small chance of success. It would be too much to say that the present basis of capitalization of new enterprises is certainty. It is no longer possibility. Perhaps reasonable probability is the accepted standard

3 *A Public Utility Enterprise* The new company may be a public utility enterprise, which will supply a necessity of city life—gas, water, transportation, electricity, or heat—to large numbers of people, grouped under the head of the "public" In this case, a special method has been worked out primarily to safeguard the public, which also protects the investor

Public service corporations must obtain the authorization of the Public Service Commission for the issue of securities. These commissions are found in almost every state In a majority of states, however, the commissions have been clothed with sufficient powers to make their work really effective. These are the states which contain most of the public utility enterprises The supervisory and regulative powers of the commissions extend to character of service, to rates and fares, and to the approval of the issue of securities In this last power, the investor finds a considerable safeguard against the improper issue of stocks and bonds.

Control of Public Service Commissions

The nature of this power over security issues is indicated by the following extract from Section 55 of the Act Creating the Public Service Commissions of New York

Any common carrier, railroad corporation or street railroad corporation organized under the laws of the State of New York, may issue stocks, bonds, notes or other evidences of indebtedness payable at periods of more than twelve months after the date thereof, when necessary for the acquisition of property, the construction, completion, extension or improvement of its facilities, or for the discharge or lawful refunding of its obligations, provided and not otherwise that there shall have been secured from the proper commission, an order authorizing such issue, and the amount thereof, and stating that, in the opinion of the commission, the use of the capital secured by the issue of such stock, bonds, notes, or other evidences of indebtedness is reasonably required for the said purposes of the corporation For the purpose of enabling

it to determine whether it should issue such an order, the commission shall make such inquiry or investigation, hold such hearings and examine such witnesses, books, papers, documents or contracts as it may deem of importance in enabling it to reach a determination.

Under this power, every common carrier corporation proposing to issue or authorize new securities must apply to the Public Service Commission for authority, and the authority will not be given until a thorough investigation has been made into the security back of the bonds and the purposes for which the money is to be spent

Standards of Commission Judgment of Proposed Issues

The primary purpose of giving the commissions power over issues of securities was to protect the public against excessive issues of capital by public service corporations. It was claimed that excessive capitalization might be used to defend rates or prices which were also excessive In the exercise of this power, however, the commissions have gone much further They have undertaken to protect the investor against unwise capital expenditures The Commission of the Second District of New York outlined its methods of procedure in cases involving the authorization of stock issues as follows

In passing upon the application for leave to issue additional capital stock, the Commission will consider

Whether there is reasonable prospect of fair return upon the investment proposed, to the end that securities having apparent worth but actually little or no value may not be issued with our sanction.

We think that to a reasonable extent the interests of the investing public should be considered by us in passing upon these applications

The Commission should satisfy itself that, in a general way, the venture will be likely to prove commercially feasible, but it should not undertake to reach and announce a definite conclusion that the new construction or improvement actually constitutes a safe or attractive basis for investment Commercial enterprises depend for their success upon so many conditions which cannot be foreseen or reckoned with in advance, that the duty of the Commission is discharged as to applications of this character when it has satisfied itself that the contemplated purpose is a fair business proposition

In practice, however, the Commission has made such careful investigation as to warrant the conclusion that for them to authorize a bond issue is equal to their assurance that the bonds are good. In the case of the

Rochester, Corning, and Elmira Traction Company, the Commission outlined in detail the methods of investigation which it proposed to follow in determining the amount of bonds which could be safely issued by a newly organized enterprise, as follows

An estimate will be made from a consideration of the results of operation of existing roads of the probable gross earnings

An estimate will be made in like manner of the probable operating expenses, taxes, and depreciation charges.

The excess of earnings over the disbursements which must be made before fixed charges can be met represents the sum which is applicable to fixed charges.

The maximum bond issue which will be allowed must be determined by the sum thus ascertained to be applicable to the payment of the interest charge.

No bond issue should be permitted creating an interest charge beyond an amount which it is reasonably certain can be met from the net earnings

Stock representing a cash investment should be required to an amount sufficient to afford a moral guarantee that in the judgment of those investing the enterprise is likely to prove commercially successful

The order authorizing such stock and bond issues will contain approximate provisions designed to secure the construction of the road in accordance with the plans and specifications upon which the authorization was made and not in excess of the actual requirements

If the allowance proves inadequate for the required purposes, an application for further capitalization may be made, upon which application the expenditure of the proceeds of stock and bonds already authorized must be shown in detail

Protection of Existing Companies by Commissions

When a public service commission has authorized the issue of securities, it accepts a very limited obligation to protect the company whose application it has authorized, not merely against the ill-advised action of its directors in using the credit of the company for improper purposes, but also against competing enterprises for which there is no public necessity and which would not, therefore, prove profitable The New York Public Service Commission for the Second District, for example, refused the application of the Buffalo, Rochester and Eastern Railroad Company for authority to issue securities for the construction of a line of railroad from Buffalo to Albany, paralleling the line of the New

York Central, on the ground that the new enterprise would not be profitable, and the New York Central would be injured without any public benefit resulting The new line proposed to interchange traffic at Albany with lines traversing New England, but the commission pointed out that the New England lines were not able to handle the traffic already delivered to them at Albany This was sufficient reason for refusing to authorize the construction of another line which would make the congestion at the Hudson River even more acute

A later illustration of this protection is the denial by the Public Service Commission of New York of certificates of convenience and necessity to eight out of ten bus lines which had been granted franchises by the City Council of Yonkers to compete with the lines of the Third Avenue Railroad Company. A very serious danger to the Third Avenue Railroad Company, was, by this refusal, averted On the other hand, there has been a general consent to applications by steam and electric railroads to be permitted to operate bus lines to supplement existing facilities In some cases, the monopoly position of the utility is definitely recognized in advance. For example, the certificate of necessity and convenience issued by the Wyoming Public Utility Commission to the Inter-mountain Water & Power Company of Denver, protects the company from competition from any other public utility company that might, in the future, attempt to provide water to its territory

While the state commissions have regularly protected utility corporations from competition which would not serve the public interest, the electric power companies in certain areas are now threatened with direct competition from federal power dam developments. Intended primarily to serve undeveloped or exhausted areas where private capital was not available, the federal power projects have in certain places come into direct competition with the private utilities. Controversy now rages and it is not possible to predict the solution to the problem Federal authorities believe that such hydroelectric enterprises will not only assist in flood control, but, by their competition, force down private power rates to "reasonable" figures

Implied Guaranty of Public Service Commissions

At the time the New York Public Service Commissions were first instituted in 1905, apprehensions were expressed by financial interests lest the new laws, because they took away from the directors and stock-

holders of corporations so much of the control which they had previously exercised over the issues of new capital, would interfere with the efforts of companies to provide funds for development Indeed, the passage of the New York law produced a feeling of consternation among bankers and investors. As the commissions have progressed with their work, however, they have so improved their technique of investigation and the control which they exercise over security issues that earlier misgivings have largely disappeared. So favorably are the public service commissions regarded by the investor, as a result of the interpretation which they have placed upon their powers, that the bond salesman offering a security whose issue they have approved, has his work of persuasion largely accomplished. In one case the issue of bonds by a Massachusetts company secured by the stocks of two other companies, and with its own stock owned by a fourth, presenting a situation almost incomprehensible, were readily sold, in the main for no other reason than that they were issued under the authority of the Massachusetts Commission Bond dealers and large investors cordially approve the control of security issues by public service commissions, because of the assurance which this public supervision gives to the investor that his interest will be safeguarded

Supervision of Railroad Issues by the Interstate Commerce Commission

The principle of supervision and authorization of railroad securities by the Interstate Commerce Commission was included in the Esch-Cummins bill, by which the powers of the state commissions are curtailed The Interstate Commerce Commission now passes upon the purposes of the issue, the security offered, and the terms of sale.

The nature of the protection given to railway investments by the Interstate Commerce Commission is shown in the adverse recommendation by the Examiner of the Commission on the application of the New York, Pennsylvania and Chicago Railway in 1925 to construct a new line across Pennsylvania. This application was for the construction of a line from Allegheny City to Easton, Pennsylvania The New York *Times*, October 6, 1925, stated that.

> The tentative report recommending denial of the application was made by Assistant Director C. V. Burnside, of the Finance Division of the Interstate Commerce Commission, and Engineer Examiner Edward Gray They held

that arguments as to damage to existing trunk-line systems (Pennsylvania, Baltimore and Ohio, and New York Central) should be given consideration, that "there is no urgent need for the proposed line," and that the existing lines are handling the through traffic between New York and the West in a reasonably satisfactory manner. Backers of the so-called Loree Route (L. F. Loree, President of the Delaware and Hudson) did not prove to the satisfaction of the Commission that there would be any great amount of new local traffic developed, and the experts held that the almost exclusive function of the new line would be the movement of through business between New York, Pittsburgh, and points west The Commission's experts indicated that even granting the need of a new line, as proposed, this line should be built and owned by the existing trunk lines

4. *Capitalization of a Going Concern for Resale* The final form of capitalization concerns the purchase of a going concern for resale to the investor Here the basis of valuation is the established earning power of the business. This is expressed in a certain number of years' purchase of earnings, as it is called, depending on the hazards of the business. A hydroelectric property, for example, sells at a higher price, compared with its earnings, than an automobile manufacturing concern. A bakery will sell at a higher price than a radio concern The usual method of handling these transactions is a sale of the stock to the bankers, a recapitalization, and the sale of the new securities to the public. Dodge Brothers, Victor Talking Machine, and the National Cash Register Company are illustrations

The stock of the Victor Talking Machine Company was sold on January 6, 1926, to a syndicate headed by Seligman and Company and Speyer and Company The authorized stock of the company was increased from \$35,500,000 to \$49,130,000, divided into first and second preferred stock, and no-par common Ten months after issue, the common stock, 575,685 shares, was selling at 42, the first preferred at 98, and the second preferred at 94. The value of the company at that date may be estimated as follows on the basis of market quotations

Common Stock, 575,685 shares, no par value	\$24,178,770
Prior Preferred Stock, \$20,934,000 par .	20,515,320
Convertible Preferred, 122,115 shares, no par value .	11,478,810
	\$56,172,900

The stock was sold to bankers at a gross price of $40,250,000. The total assets of the company, about the time of sale, were estimated at $54,161,062, of which $25,129,913 represented current assets This value was slightly below the market value of the stock after a sufficient time had elapsed for the market quotations to find their true level Earnings for 1926 were $8,423,177, so that the bankers arranged for an aggregate of new securities upon whose market price approximately 15 per cent return had been earned in 1926.

Dodge Brothers was reported sold to Dillon, Read and Company in 1924 for $146,000,000 cash. The profits for that year were $17,520,000, or 12 per cent on the purchase price. Its value in 1927, exclusive of the Class B common stock, which had the exclusive voting power and was presumably held by the bankers, was about $145,500,000, on the basis of market quotations for its securities, slightly less than the purchase price. The net earnings in 1927, three years later, had fallen to $9,641,426. The property was, therefore, classified as low risk, sold originally on a 12 per cent basis, and evidently purchased at too high a price.

Bases of Valuing Industries for Sale

Dewing, in his Financial Policy of Corporations, quoting Badger of the Harvard Graduate School of Business Administration, gives the following suggested basis for purchasing going concerns

Class 1. Low risk, 12—14.99 per cent
Class 2 Medium risk, 15—19.99 per cent
Class 3 High risk, 20—25 per cent
Class 4. Very high risk—over 25 per cent

The percentage figures here given for each of the risk classes, represent the approximate rate of return which a prudent buyer would expect to receive upon that sum of capital required for the purchase of a business as a going concern. In other words, if a business was to be purchased, and its history and record of earnings indicated considerable stability and likelihood of continued success, so that the purchaser could classify it as one of low risk, he would be safe in buying it if the average earnings available for dividends over a period of years, had been equal to 12 to 14.99 per cent upon the amount of his purchase

price A single year's earnings is not considered an adequate measure of earnings stability.

Into which class a business falls can only be determined by consideration of the special circumstances surrounding it. A manufacturing business, such as the Eastman Kodak Company, with a long and uninterrupted career of success, enjoying a monopoly founded on patents and high prestige, based on current market quotations for the common stock, is much more valuable than, for example, a sugar-refining company which has no special advantages except large capital, and which is exposed to competition.

Industries vary in selling value, not only with earnings but even more with the degree of investment favor which they enjoy As an extreme case, a lighting company in Indiana whose market value, expressed in stocks and bonds, was $150,000, may be compared with a newspaper property in the same town and with the same earnings, but valued by its owner at $15,000 Until the passage of the Public Utility Holding Company Act of 1935, the electric light and power industry enjoyed unusual investment favor, largely because of the inherent stability of earnings and the steady growth in demand for its product

This investment reputation is constantly changing. Interurban electric companies, in high repute before the War, now can not be sold, and New England textile mills are in very poor favor with the investor, although a few years ago they stood high. The value of gas properties is decreasing with the growing competition of electricity, while the value of oil companies has been kept down below the high levels of the early twenties, in spite of the continued increase in the consumption of gasoline, by the excessive production of crude oil Each case of valuation, in the last analysis, must be considered separately, and stock market quotations averaged over reasonably long periods are the best, indeed the only, indication of value.

CHAPTER 17

THE USE OF BONDS AND PREFERRED STOCK IN THE CAPITAL STRUCTURE

Use of Fixed-Return Obligations in Financial Plan

The financial plan will often call for the issue of bonds and, if that fails, for the issue of preferred stock. The reason for preferring this method of financing lies in the nature of bonds and preferred stock. The purchaser of a corporation bond, in return for security of income and principal, makes no demand to share in the earnings of the company above the rate of interest named in his bond.

With the preferred stockholder, the situation is the same. In return for a preferred claim to a definite rate of dividend, the share of the preferred stockholder, unless his stock is participating with the common stock in distributed profits above his stated dividend, stops with his stated dividend. All additional distributed profits go to the holders of common stock. If, therefore, in the financial plan, all, or a large part of the necessary money can be secured by selling bonds or preferred stock, and if the expectations of the promoters that large profits will be earned are realized, it is profitable, from the promoter's standpoint, to employ this method.

Suppose that $1,000,000 is required to carry through the consolidation, or build the plant, or construct the railroad. The earnings of the enterprise are estimated at the annual rate of 20 per cent on the capital, or $200,000. This money can be raised either by the sale of bonds or by the sale of stock, or both methods can be used in combination. If the $1,000,000 can be provided by the sale of bonds bearing 6 per cent interest, the promoters and bankers will have common stock which can share surplus earnings of $140,000 a year. For this stock, they may have paid only the cost of securing the options and selling the securities. Although they may surrender part of this common stock to be given as a bonus with the bonds, they can usually retain a sufficient amount to control the company. If, on the other hand, they sell common stock

to obtain this $1,000,000, they must admit each share of stock to full participation in profits Assuming that 10,000 shares of common stock are issued, and that the promoters and bankers, in return for options, franchises, contracts, and services, obtain 5,000 shares, and assuming further that $80,000 is distributed, each share will receive $8. Up to this point, the fact that all stock is common stock makes no difference to the banker's and promoter's stock interest Suppose, however, that earnings increase to the point where $16 per share can be paid, or $160,000. With only one class of stock issued, each share will receive its proportionate part of this dividend With a division of the stock between 8 per cent preferred and common, however, the preferred stock will receive $40,000 and the common $120,000. By including fixed interest or fixed dividend elements in the capitalization, all increases in earnings go to the common stock. Furthermore, when the security is good, preferred stock can be more readily sold and at higher prices than common stock

Preferred Stock in Reorganization

Preferred stock has been largely used in original financial plans. Of the corporations listed on the New York Stock Exchange, there were outstanding October 1, 1937, 425 issues of preferred stock Many of these issues were made to obtain new capital, but the majority were original issues of three classes of companies at three different periods A large number of preferred stocks were issued during the nineties by railroad companies organized to succeed other companies which, by reduced earnings or unwise accumulations of debt, had been thrown into bankruptcy These preferred stocks were issued in place of junior bonds as more nearly reflecting their position in reference to the earnings. It was not considered certain by the reorganization managers that the new companies could earn, in good years and in bad, enough money to pay the interest on these junior bonds If new fixed interest bearing bonds had been issued, another depression might again force the companies into bankruptcy, due to their inability to meet the interest charges. The alternative security was income bonds, but these bonds were not at that time popular, and few of them were issued Instead, the junior bondholders were given 4 per cent non-cumulative preferred stock Some of the companies issuing these stocks, which were non-callable and are still outstanding, are the Baltimore and Ohio, Norfolk and

Western, Atchison, Union Pacific, Southern Railway and Northern Pacific.

By changing a large amount of their bonds into preferred stock, however, if the company succeeded, the old bondholders, now preferred stockholders, would receive their former return, and if the company did not succeed in bringing its earnings up to a point permitting payment of preferred dividends, since these preferred stocks were without exception non-cumulative, the income account would not be burdened with the payment of unearned dividends paid in order to protect the value of the common stock, nor would there be any accumulation of unpaid dividends to depress the value of the common stock

Preferred Stock in Combinations

The second group of preferred stocks were issued in connection with the promotion of the industrial combinations, usually known as industrial trusts, most of which were organized between 1898 and 1903 Listed below are forty-three companies in this group, still in operation.

Name	Date of Incorporation	Amount of Preferred Stock Authorized
American Can Co	1901	$44,000,000
American Bank Note Co.	1906	5,000,000
American Car and Foundry Co	1899	30,000,000
American Hide and Leather Co	1899	17,500,000
American Locomotive Co.	1901	25,000,000
American Woolen Co	1899	25,000,000
Bethlehem Steel Corp.	1904	15,000,000
Continental Baking Co	1924	200,000,000
Corn Products Refining Co	1906	30,000,000
International Harvester Co	1902	60,000,000
Johns-Manville, Inc.	1901	2,000,000
National Biscuit Co.	1898	25,000,000
Pittsburgh Coal Co	1899	32,000,000
Remington Rand	1927	26,000,000
United Biscuit Co. of America	1927	2,000,000
General Baking Co	1911	10,000,000
Ward Baking Corp	1923	50,000,000
Consolidated Cigar Corp.	1919	5,000,000

Name	Date of Incorporation	Amount of Preferred Stock Authorized
General Cigar Co., Inc.	1906	$5,000,000
United States Leather Co	1893	64,000,000
United States Rubber Co	1892	25,000,000
United States Smelting, Refining and Mining Co	1906	37,500,000
United States Steel Corp.	1901	550,000,000
Virginia-Carolina Chemical Co	1895	20,000,000
Allis Chalmers Co	1901	25,000,000
American Agricultural Chemical Co	1899	20,000,000
American Beet Sugar Co	1899	5,000,000
American Brake Shoe and Foundry Co.	1902	3,000,000
American Ice Co.	1899	30,000,000
American Radiator Co.	1899	5,000,000
American Steel Foundries	1902	19,540,000
Borden's Condensed Milk Co	1899	7,500,000
Certain-Teed Products Corp	1917	15,000,000
General Asphalt Co	1903	14,000,000
International Mercantile Marine Co.	1902	60,000,000
International Paper Co	1898	25,000,000
International Silver Co	1898	9,000,000
National Enameling and Stamping Co	1899	10,000,000
Otis Elevator Co.	1898	4,500,000
Republic Iron and Steel Co	1899	25,000,000
United Shoe Machinery Corp	1905	15,000,000
United States Envelope Co	1898	4,000,000
Worthington Pump and Machinery Corp	1916	21,000,000

These combinations were promoted as follows. Promoters obtained options on a number of wire plants, or copper mines and smelters, or flour mills of companies operating in the same industry. These options fixed prices at which the owners of these separate companies would sell their plants. The prices were very liberal because they were not, save in a few cases, cash prices. They were prices which were to be paid in securities of a new corporation. The promoters were usually unable to pay more than a minor part of the purchase price of the properties which they held under option, in cash. The only source from which this cash could be obtained was from the sale of securities of the new

company. These sales must be made to bankers or underwriters who would buy or guarantee the sale of the securities at a price, expecting that they would be sold to the public at a higher price. These bankers received compensation for the risk they assumed in the form of a commission or bonus of stock, as well as in a low price for the securities which they bought or whose sale they sponsored The larger the amount of cash which the promoters must provide, the smaller was the bonus which must be given to the underwriters This bonus was a deduction from the promoter's profit, and he tried to reduce this to the lowest terms It was, therefore, to the promoter's interest that as much as possible of the purchase price of the separate plants which the new company was to buy, should be paid in securities of the new company It also was of great assistance in the sale of the securities of the new company if it could be advertised that the owners of many plants had accepted stock, and in some cases, bonds, for their properties

Another sales consideration was the fact that stock given in exchange for plants, secured the advice and assistance in the new company of former owners of its constituent companies These men were experienced in the business, and their continued cooperation was one of the most valuable assets of the new corporation, and was so advertised Indeed, without this cooperation, the new company would be discredited from the outset In the minds of the public who were expected to subscribe to the new securities, the stock of the companies with which the owners of the plants consolidated would have nothing to do, would be worth very little

It should also be noted that the percentage of the new securities issued to purchase these plants which would be offered to the public, decreased as the percentage of the purchase price accepted by the owners in the form of new securities was increased. The stock issued in exchange for plants could, by previous arrangement, be held off the market for a reasonable time until the underwriters and promoters had an opportunity to market their own holdings If, however, most of the plants had to be purchased with cash, the supply of securities offered for immediate sale might be so large as to make them difficult to sell This would increase the risk which the underwriters assumed The bonus which they demanded would be larger, and the price at which they took the stock from the promoter would be lower The amount of the securities which the promoter must give up to the bankers who supplied his

cash requirements, increased more rapidly than the amount of money furnished That is to say, if the promoter needed $4,000,000 to complete his purchase of plants for the new consolidation, he might obtain this amount in exchange for $7,000,000 of stock, while, on the other hand, if many of the owners refused to accept securities and the cash requirement was increased to $8,000,000, the promoter might have to give up $20,000,000 of stock to obtain this larger sum, if indeed he was not obliged to abandon the scheme altogether

A number of the consolidations attempted at that time fell through because the owners demanded too much cash, and the bankers refused to furnish it The flotation of these industrial trusts, in short, depended upon the willingness of the owners of the individual companies united through the consolidation, to become stockholders in the consolidated company It was necessary that a number of these owners—the more prominent among them—should identify themselves with the new enterprise in order to make it easy to sell its securities This cooperation need not be permanent. If they desired, after the promoter and underwriter had marketed their securities, the owners of the separate companies could also dispose of their holdings Temporarily, at least, the new consolidations must number among their stockholders a large majority of the former owners of its plants

Cumulative preferred stock was issued, with hardly an exception, by the promoters of the industrial trusts, together with an equivalent amount of common stock The purpose of this distinction between preferred and common stock was to induce the owners of the plants to accept stock in payment for their property, and in this way to lessen the amount of cash required for the financing

The individual owners might have hesitated to accept common stock for their plants if the amount of stock offered was measured by the present value of the plants, plus the additional value which it was expected that the combination would give If the promoter had overestimated the profits from the combination, the owners who took this stock for their property on the basis of an agreed evaluation, might suffer a loss. Suppose, for example, they had accepted $30,000,000 out of a total capitalization of $45,000,000 in exchange for the plant, and were given to understand by the promoter that this $30,000,000 would pay 7 per cent in dividends and therefore be worth its face value either to hold or to sell Events may prove that the promoter over-

estimated the earnings of the combination, which were only sufficient for a 2 per cent or 3 per cent dividend, representing a value of 40 or 50 for the stock.

The promoter would not suffer from this mistake, save in the reduction of his profits But the owners would find the value of their property converted into stock had shrunk 50 per cent In order to protect themselves against such a shrinkage, the vendors of these plants insisted upon a division of the stock into preferred and common stock, and upon the payment to them of the agreed value of their plants in preferred stock, with a bonus of common, so that if the calculations of the promoter proved wrong, there would probably be enough to pay a liberal dividend on the preferred stock, and the effect of his miscalculations would fall upon the common stock

In addition, of course, to the preferred stock, most of the vendors who sold their plants to these industrial combinations demanded and received substantial bonuses of common stock which had little real value except as increasing earnings might some day make it possible to pay dividends upon this junior issue.

Use of Preferred Stock by Holding Companies

The third grand division of preferred stocks is made up of the preferred stocks issued in connection with the promotion of the public utility holding companies These companies were organized to group under one ownership sometimes several hundred light and power plants located in all parts of the country In one case—the Electric Bond and Share Company—the constituent companies are located in thirty-two states In the formation of these companies, which was accomplished by the organization of a group of holding companies, one piled on top of the other, preferred stock was used not only to buy the original operating companies, but also to pyramid[1] the earnings of the holding companies received in the form of dividends and fees from the operating companies This was brought about by exchanging preferred stock of a holding company for the common stock of another holding company But in the total stock of the acquiring company, the earnings in excess of the amount necessary to pay dividends on the holding company's preferred stock were capitalized as common stock In some companies, for example the Associated Gas and Electric, this operation was repeated

[1] See *Post,* Chapter 38

three times until the final holding company was erected upon three layers of holding companies, each in turn issuing preferred stock (or in some cases, bonds) to buy the common stocks of the holding company below it, and issuing its own stock against the surplus of the dividends and fees of the predecessor company over the amount needed to pay the dividends on the preferred stock issued to buy it.

Most of these preferred stocks were issued during the period of public utility expansion which followed the War, and which culminated in 1929 Examples are American and Foreign Power, 3 issues of preferred, American Power and Light, 2 issues, Electric Bond and Share, Cities Service, National Public Service, National Power and Light, Standard Gas and Electric, Associated Gas and Electric, Commonwealth and Southern, Consumers Power and Light, American Super Power and the North American Company

Preferred Stock Used by Investment Companies

Fourth, the use of preferred stock was also frequent in the case of the management investment companies, frequently called investment trusts, during the post-War period A large number of these were organized by the issue of preferred and common stock, the proceeds being used to purchase the stocks of operating companies in the belief that the dividends on these stocks would be sufficient to enable the promoters of the investment companies to pay dividends on their preferred stock, most of which was sold to the public, and also to have substantial earnings remaining for their common stocks These expectations were, in most cases, never realized. It was a significant feature of the development of these management companies that the amounts of preferred stock which they sold to obtain cash were, in nearly all cases, much larger than the amount of their common stock. This preferred stock, moreover, was usually made non-voting The sponsors of these so-called investment trusts were, in many cases, investment bankers, and they bought the common stock As long as the amounts of common stock were small as compared with the preferred stock, and as long as the preferred stock was non-voting, as above stated, they obtained, by the outlay of a comparatively small amount of cash, the control of large sums of money which they could sometimes use for their own profit in connection with their banking business. Many of these management trusts have since expired, and their assets have been sold to a few

of the survivors The Atlas Corporation has been conspicuous in buying up the stocks of management companies in order to obtain their assets at low figures After the purchase, the investment trusts which formerly owned the assets were dissolved

Writers' Attitude toward Debt

Text writers in finance have quite generally taken the position stated baldly in the first paragraph of the first book on corporation finance, Thomas L Greene's *Corporation Finance*, "The business man or firm must borrow money."

Graham and Dodd, in their well-considered volume, first published in 1934, reflect the most enlightened modern view of long-term debt financing "The proper theory of bond financing, however, is of quite different import A reasonable amount of funded debt is of advantage to a prosperous business, because the stockholders can earn a profit above interest charges through the use of bondholders' capital It is desirable for both the corporation and the investor that the borrowing be limited to an amount which can safely be taken care of under all conditions." [2] Generally speaking, this is the accepted opinion of text writers, and it is the fixed belief of all investment bankers and legislators

It is a fair statement that a belief in the value of debt as the primary agency of raising capital is fixed in the minds of those who write about finance and of those who practise it

The use of long-term debt to obtain money for construction and, to be discussed later, for expansion, is based upon a theory which is widely accepted and in fact not very seriously questioned—the theory of trading on the equity. For the elaboration of this theory Hastings Lyon, in a book published in 1912, stated the principle as follows

> The business man mortgages his property to get more money in his business, in order that he may engage in it on a larger scale, and all to the end that he may make a greater return on his own capital invested .. To take the simplest possible case, a manufacturer, say, finds that in good years he is making 15 per cent on his capital of $20,000 He reasons that if he can make 15 per cent or even 10 per cent on capital in his business, he will make much more for himself by borrowing money at 6 per cent, or even at 8 or 9 per cent Thereupon he goes into the money market in one form or another and finds that, though he can borrow $20,000 at a nominal face

[2] Graham and Dodd, *Security Analysis* (McGraw-Hill Book Company, Inc, New York, 1934), p 84

interest of 6 per cent, a further actual discount brings the real interest up to 8 per cent He borrows $20,000 on these terms Suppose he is able to continue making 15 per cent on the invested capital Before borrowing, his affairs at the end of the fiscal year stood like this

Personal capital invested	$20,000
Percentage earned on capital	15 per cent
Return on capital	3,000

After borrowing, his annual statement would show

Personal capital invested	$20,000
Borrowed capital invested	20,000
Total capital	$40,000
Percentage earned on capital	15 per cent
Total return on capital	6,000
8 per cent on borrowed capital	1,600
Return on personal capital	$4,400

That is to say, by borrowing at 8 per cent he has increased the return on his own investment from 15 per cent to a point where it now makes him 22 per cent.

Suppose, however, an especially bad year, either in business of that particular kind, or in general business conditions, comes along, and the proprietor can make his enterprise earn only 5 per cent on the capital invested How would his annual statement stand then? It would show

Personal capital invested	$20,000
Borrowed capital invested.	20,000
Total	$40,000
Percentage earned on capital	5 per cent
Total return on capital	$2,000
8 per cent on borrowed capital	1,600
Return on personal capital	$400

In this bad year the proprietor has made only $400, or 2 per cent on his own capital, as a result of borrowing, whereas, if he had not borrowed at all, he would have made 5 per cent, or $1000 In the bad year he has lost $600 by trading on the equity against the $1400 he made in the good year by following the same policy Of course the proprietor expects that the gains of his good years will much more than offset the losses of his bad years [8]

[8] Hastings Lyon, *Corporation Finance* (Houghton Mifflin Company, Boston, 1912), pp 50-52

Professor Lyon's business man is, in our discussion, represented by the promoters and bankers who are formulating the financial plan for a new company Their attitude toward trading on the equity has already been expressed in the opening discussion.

These writers fully recognize the danger of trading on the equity Their justification for it is limited to financial situations in which a large surplus over interest charges may be earned on borrowed capital As the quotation from Hastings Lyon shows, he fully recognizes the losses from the policy of trading on the equity in bad years, but he states that the business man who follows this policy expects the greater profits of good years to offset the lesser losses of bad years

Graham and Dodd are careful to point out the danger latent in following the policy of trading on the equity, except where the necessary conditions are met and the necessary precautions taken Their statement upon this point is as follows

> Financial policies followed by corporations and accepted by the public have for many years run counter to these logical principles The railroads, for example, have financed the bulk of their needs through bond sales, resulting in an overbalancing of funded debt as against stock capital. This tendency has been repeatedly deplored by all authorities, but accepted as inevitable because poor earnings made stock sales impracticable But if the latter were true, they also made bond purchases inadvisable [4]

Thus we have a statement of the leading argument for bond financing, namely, that it is advantageous, when it is safe, to borrow money at 5 or 6 per cent when 12 or 20 per cent can be earned on the money borrowed.

There are other advantages in bond financing from the viewpoint of promoters and financiers Bonds are popular with investors, and can be more readily sold than stock Bonds will be taken in larger unit sales by institutional investors, which means a lower cost of distribution The raising of capital by the sale of bonds leaves the control of the company in the hands of the stockholders with whom the promoters are usually closely identified A familiar recent argument in favor of bond financing, which is also derived from the general principle of trading on the equity, is summarized in the one word "leverage" This is the situation which arises when a company has most of its capital liabilities

[4] Graham and Dodd, *Security Analysis* (McGraw-Hill Book Company, Inc, New York, 1934), p 84

in bonds or non-participating preferred stock. The common stock, receiving all of the distributed earnings above the amount necessary to pay interest or preferred dividends, is greatly benefited by any substantial increase in earnings, because the dividends paid out of this increase in earnings, go entirely to a limited amount of common stock which, in the case of public companies, quickly responds in appreciation in market value, to the increases in distribution which increased earnings make possible. These are all weighty arguments in favor of bond financing.

It has long been recognized, however, that bonds can not be issued safely by all classes of companies The investor will not buy bonds, except at prohibitively low prices, which do not meet the established standards of security When a company is obliged, because of the investor's passive opposition, to overcome that opposition by paying high interest rates, either on the bonds themselves or because they are sold at a heavy discount, the advantage of trading on the equity by including bonds in the financial plan is greatly reduced.

Non-Specialized Property as Security for Bonds

We classify industries into those which furnish satisfactory security for the issue of bonds and those which do not In the discussion of the mortgage as security, we have seen that great attention is paid to the enumeration of the items of property of a corporation, and that this property is carefully segregated to protect the holders of the bonds. When this property is non-specialized—that is, when it can be put to a variety of uses, so that it can readily find a purchaser—for example, a loft building or an office building, or stocks of finished goods, or materials—then the property furnishes the security for the loan, with earnings in a secondary position When, however, the property of the company is specialized to the use of a particular business, such as a railroad or manufacturing plant, where the business must be carried on in a certain place and by people who are skilled in its management, and where the property, once devoted to a particular use, can be turned to no other use, the real security of the creditor is not the general sales value of the property, but the earning value of the property, based upon the amount which can be earned by its employment in a specialized field With a mortgage on centrally located real estate, properly valued at the time the mortgage was placed, the selling value of the real

estate can usually be realized Even here, however, much attention is paid by the investor to the rentals received or to be received

Here it must be noted, however, that in large-mortgage-secured debts, for example, on office buildings, care is usually taken, before the bonds are offered to the public, to lease for long terms a sufficient amount of floor space to provide for fixed charges. An office building may cost $7,500,000. This building houses thousands of tenants, each one contributing to its earnings These tenants represent a variety of occupations—professional men, lawyers, accountants, engineers, financial houses, representatives of out-of-town concerns, large manufacturing corporations, etc, their names being a cross-section of the business life of the country. Every month, the tenants are changing as the leases expire Vacancies occur, new tenants enter, while underlying the rental structure are entire floors leased for long terms to large corporations. This is a good example of a generalized demand for office accommodation, a value resting upon the broadest possible basis of diversity of business enterprise Any group, for example, silk manufacturers' representatives, could move into a building of its own, and the places would be quickly filled by some other group. Such a building could be mortgaged safely for a high percentage of its cost.

As an extreme instance of specialized value may be mentioned an immense factory, built in a southern state by an engineering firm of high repute, to exploit an industrial process which promised to revolutionize an industry Not only was the plant built at great expense, but a factory town, complete with all municipal services—water supply, sewerage, and lighting—was erected to house the workers The process did not succeed and the entire investment, an amount running into millions, was lost. This is an example of value depending entirely on earnings, and earnings depending on the success of one specialized process. The security of the creditors is the earning power of the business which is carried on in the factory and when earnings die, value dies.

Earning Power the Real Security of Bonds

Furthermore, a business is not an aggregate of physical property, but consists of physical property—buildings, boilers, machine tools—plus a sufficient amount of working capital, plus bank and trade credit sufficient for the needs of the business, plus an industrial opportunity, plus the

organization and ability to operate the business.[5] The corporation owning this business borrows the money, and the value of the business is based upon its earnings. The physical property, which is set aside with such a profusion of formality in the mortgage, is merely the visible symbol of its earning capacity. Without the plant, it is true, earnings would be impossible, but the plant has little value unless the spirit of profitable life is breathed into it by an efficient organization. In estimating the ability of different classes of enterprises to furnish security for bond issues, we must first take account of earnings.

Since the bondholder is solely interested in the security of his principal and regular payment of his interest, and since both security and interest depend upon income, the companies with the most stable earnings furnish the best security for bonds. Stability of earnings depends upon (1) the possession of a monopoly; (2) good management, and (3) the character of the business.

Definition of Monopoly

Monopoly is exclusive or dominant control over a market. The more complete this control, the more valuable is the monopoly. The advantage of monopoly lies in the fact that the prices of services or commodities are controlled by the seller rather than by the buyer, so that the principle of charging what the traffic will bear can be applied in fixing prices. By this is meant that the seller, controlling the market, charges those prices which will yield the largest return in profits. When the demand is strong, prices can be advanced. When the demand falls off, they can be reduced to stimulate buying. Moreover, monopolies can guarantee prices for long periods, so that the buyer has no encouragement to hold off for better terms, and so that the "higgling of the market," so costly to the seller anxious for business, is eliminated. In the long run, the returns in profits from monopoly are greater than when the consumer is able to play off one seller against another and so secure concessions in prices.

[5] When Dr. Samuel Johnson was valuing the Thrale Brewery in London, he exclaimed, "Sir, we have not here to do with a mere commodity of pots and vats but with the potentiality of becoming rich beyond the dreams of avarice."

Classification of Monopolies

Monopolies are of various origins. The five most familiar are (1) franchises, the right to use public property for private purposes, for example, the furnishing of light, power, water, communication, and transportation, (2) control of sources of raw material supply such, for example, as that which the United States Steel Corporation exercises over the Lake Superior ore deposits, or the water power and timber reserves of the International Paper Company, (3) patents, which give the exclusive right to manufacture an article, the most familiar recent illustration being the capitalization of radio patents in the Radio Corporation of America, (4) trade marks, in which appear the value of habits of thought—association of ideas—built up in the minds of millions of customers by the spending of immense sums to identify "Royal" with baking-powder, "Ivory" with soap, "Fels Naptha" with cleaning powder, and "Kodak" with cameras The importance of advertising is rapidly increasing, and the rising scale of advertising expense gives an extraordinary advantage to the large concerns which can meet the requirements of nation-wide propaganda (For example, the Lambert Company, manufacturers of Listerine, in a bankers' circular in 1926, vouches for the statement that, starting in 1921 with practically no advertising, each month's increase in advertising has been met during that month by an increase in profit as great as the advertising increase and a substantial additional profit. This company in four years spent over $4,400,000 in advertising.) (5) The high cost of duplicating plant is a form of monopoly This secures the railroads in thickly settled territory, where land values are high, and where terminal sites are especially costly, against competition from the duplication of their facilities Of these forms of monopoly, those conferred by franchises and by high costs of duplication are most valuable from the standpoint of bond security Next comes possession of supplies of raw material, next advertising monopoly, and last, patent monopoly

Importance of Management to Earnings

Stability of earnings also depends upon good management. This means not merely economical operation, but cultivation of new business The success of the Ford Motor Company has been mainly due to the genius of Henry Ford. He has, from the beginning, dominated its

policies, production, finance, and sales Without his direction, as a number of bankers testified, in a tax hearing at Washington, they would not place a high value upon its property. The success of the United States Steel Corporation was largely due to Mr. Elbert H Gary, Chairman of the Board. He carried the company through the dangers of the government suit for dissolution. He maintained a dominating position in the trade without antagonizing competitors, and he stabilized competition so that prices have been maintained without agreement or consent, but merely by the force of example. In some cases, the appointment of Mr. Sewell L Amy in 1931 to head Montgomery Ward, for example, a change in management was immediately followed by a radical improvement in earnings. The scope of modern business is so tremendous that wrong decisions are enormously costly. The high salaries paid the large executives represent a small fraction of the value of these men to their companies. A striking illustration of the cost of mistakes is shown by the difficulties of the Servel Company before its reorganization in 1927 This company manufactures gas refrigerating units Originally these were contained in wooden boxes, protected by paint against warping The summer of 1926 in the eastern territory was excessively damp The paint cracked, boxes warped, and it was necessary for the company to replace 6,000 units with others, housed in metal boxes Some official was responsible for this mistake which wrecked the corporation.

Importance of Stable Demand

Stability of earnings depends finally upon the breadth of the demand. In manufacturing industries, for example, those enterprises which produce raw materials and the necessities of life have a more stable demand than those which produce highly finished articles and luxuries Industries which depend upon the capital market, such as machinery and building materials, are seriously affected by depression in the securities market. There is a close connection between the demand for machinery and the volume of securities sales Industries which rely largely upon export demand are much influenced by foreign competition Articles sold on the instalment plan have difficulty in maintaining their sales in territories where strikes or depression seriously reduce employment. One of the most prized advantages of consolidation is the broadening of demand by taking in the producers of allied lines. An

illustration is the wide diversity of the Du Pont products, and the broad basis of demand upon which the business of the General Motors Corporation is founded, with "a car for every purse," and the addition of electric refrigerators, Diesel engines, and home lighting and power plants to the manufacture of automobiles.

We may classify enterprises according to the quality of the security which they offer for an issue of bonds. Mining enterprises—coal, iron, copper, lead—furnish a basis for bond issues only when the extent of the resources is known. When a bed of coal or a deposit of ore has been surveyed and its contents estimated, it furnishes a basis for a bond issue up to a moderate percentage of its selling value. This value, like the value of real estate, is not based on a free market. There is no exchange on which coal lands, for example, can be readily sold. At the same time, for proven mineral properties, there is a market value based on the amount which can be realized from the operation. Industrial enterprises, until recent years, were mortgaged, as a rule, only when possessed of mineral properties or salable real estate. The limit of bond issues is narrow and bears a close relation to the selling value of the property.

Public service corporations, operating under franchises liberal in terms, and when the demand for their services is increasing, furnish excellent security for bond issues. The monopolies of water and electric light and power, which have the exclusive right to serve the consumer for a term of years at prices which leave a large margin over cost, are so perfect that the bondholder runs little risk in lending to a high percentage of the cost of the property. In this field of municipal public service companies, the larger the city, the sounder the investment. In a large city, the overhead, or interest cost, is spread over the maximum number of units, and the plant is utilized to its full capacity. On the other hand, the cost of extending certain kinds of municipal services—for example, transportation in the form of subways—may be so great that the returns for many years may be uncertain.

Railroads, until recent years, furnished the best basis for bond issue. The high reputation of railroad securities was due (1) to the stability of the demand for the transportation service which is rendered to every industry, (2) to the high cost of duplicating railroad plants which secures existing lines in the possession of valuable territories, and, within the limits imposed by law, enables them to fix uniform rates on freight and passenger traffic, and (3) the rigid and salutary control of their

activities by the Interstate Commerce Commission, a control which, among other advantages, protects the railroads from competitive construction.

The monopoly position of the steam railroads, since 1930, has been weakened by the invasion of other agencies of transportation. The bus, the private automobile, and, recently, the airplane have greatly reduced passenger traffic Boats, trucks and pipe-lines have cut into freight traffic Central electric power plants, because they produce a given quantity of power more economically in terms of coal burned than do small individual plants, have reduced the amount of coal transported. The grain export trade before 1939 had almost vanished Industries are moving nearer to the consumer. Interior cities and towns are developing to a more self-contained position These influences have destroyed railway monopoly Railway bonds represent a capitalization of monopoly profits. With those profits reduced, the security of railway bonds declines There is little hope that American railroads, no matter what rates they are permitted to charge, will show a 5¾ per cent return on their present value. This situation is largely independent of the depression, although that, of course, is primarily responsible for the serious decline in railway earnings since 1930 These competitive forces operating before the depression were strengthened by the depression and will operate after the depression is ended Certain classes of traffic—coal, ore, lumber, sand, cement, and grain—will go by rail only when they do not go by water. Passenger traffic may be increased by increasing speed and providing more comfortable cars. Truck competition may be partially met by a combination of truck and freight-car delivery, giving door-to-door service. Even with all these corrective factors operating, however, it is doubtful whether railway earnings will increase so far as to restore railway bonds to their former premier investment standing.

Determining the Amount of Bond Issue

We now take up the amount of bonds which may be issued. The amount should not be so great as to impose upon the corporation a burden of interest charges which is above, or even equal to, a conservative estimate of the earning power of the company under the worst conditions which it is likely to meet. If a corporation does not pay its interest, and is put into bankruptcy, its affairs are thrown into confusion Even though it is reorganized without any interruption to its business, serious

damage has always resulted. In issuing bonds, therefore, conservative financiers keep in mind the danger of business depression or other unforeseen contingencies, and regulate the amount of debt to guard against the consequences of any such untoward event.[6]

The considerations which relate to the stability of different enterprises as security for bonds can also be employed to determine the percentage of income which can safely be represented by interest on bonds The more irregular are the profits, e g , in the steel industry as compared with electric light and power, the smaller is the percentage of earnings which can safely be represented by bond interest

To summarize the still prevailing opinion as to the inclusion of bonds in the financial plan, we submit the following Trading on the equity by the use of bonds is sound financial practice The use of this method, when the situation of the company permits the earning of large profits on money contributed, is recommended. At the same time, it is recognized that bonds may be inadequately secured when issued by companies whose earnings are exposed to hazardous fluctuation, and may easily cause the issuing company to fall into serious difficulty which may eventuate in bankruptcy and drastic reorganization.

Effect of Inability to Pay Debt

We now return to the theme of our discussion. The inability to pay interest on long-term debt, as well as the overuse of short-term debt, is mainly responsible for the complexity of damaging and disastrous phenomena which are grouped under the general heading of business depression. At the same time, the prudent use of long-term debt in the capital structure may be, when the proper precautions are taken, productive of larger returns to the stockholders of the corporation than would be possible if the provision of capital was confined to the sale of stock. The question now arises, in view of the danger inherent in bond financing, and recognizing the faults of bond financing—where does the balance fall? Is the issue of bonds to be generally condemned, and are the cases where bonds can be safely and profitably issued to be classed as exceptions to the general rule? Or is proper bond financing to be approved

[6] Railroads and public utilities have always assumed a greater burden of interest charges in reference to earnings than have manufacturing companies In view of recent railway history, this accepted opinion of the stability of railway earnings, based primarily on diversity of traffic, must be revised

as a capitalization policy, while warning against the abuses involved in the unwise use of bonds? Always remember the point, which can not be too often or too strongly stressed, that most of the financial troubles of the world are due to the abuse of long-term bond financing, and that, if this method of raising money should be generally abandoned in favor of financing by stock or out of profits, most of these troubles could be avoided

Practice of Companies in Use of Debt

To answer this question we do not need to depend on theory. We can take as our guide the practice of the most prosperous and the best managed corporations in the United States. These companies, as a settled policy, do not primarily rely upon the issue of bonds. When compelled, by an emergency (for example, sudden depreciation in inventory which catches them unawares) to raise a large amount of capital by the sale of bonds which, as already stated, are always the easiest securities to sell, they treat the bonds, although they may be long-term, as temporary obligations, and retire them as soon as possible, either out of profits, by the sale of stock, or even by the sale of some of their capital assets. The evidence of the truth of this statement is overwhelming It is contained in the financial history of the most prosperous companies now listed on the New York Stock Exchange. The following companies, among others, had no funded debt in 1939.

Air Reduction
Allied Chemical and Dye
American Can Co.
American Car and Foundry
American Locomotive
American Snuff
Borden Co
Burroughs Adding Machine Co
Cannon Mills Co.
Caterpillar Tractor Co.
Coca-Cola Co.
Cluett, Peabody and Co., Inc.
Colgate-Palmolive Peet Co.
Columbian Carbon Co.
Congoleum-Nairn, Inc.
Congress Cigar
Continental Baking
Continental Can
Curtis Publishing Co.
Diamond Match
Distiller's Corp—Seagram's, Ltd.
E. I Du Pont de Nemours and Co
Eastman Kodak
Electric Auto-Lite Co.
Electric Storage Battery
Endicott Johnson Corp.

First National Stores
General Electric
General Foods
Great Western Sugar Co.
Harbison-Walker Refractories Co.
Hercules Powder
Hershey Chocolate
Homestake Mining
Ingersoll-Rand
International Harvester
International Nickel Co. of Canada, Ltd.
International Shoe Co.
International Silver Co.
Island Creek Coal Co.
Johns-Manville Corp
Kennecott Copper Corp.
S H Kress and Co
Kroger Grocery and Baking Co.
Libbey-Owens-Ford Glass Co
Liquid Carbonic Corp.
Mack Trucks
Mathieson Alkali Works, Inc.
Maytag Corp
McCall Corp
Montgomery Ward and Co., Inc
Philip Morris and Co., Ltd.
Nash Kelvinator Corp.
National Biscuit Co
National Cash Register Co
National Enameling and Stamping Co.
National Lead Co.
Otis Elevator Co.
Owens Illinois Glass Co.
Pacific Mills
Packard Motor Car Co.
Parke Davis and Co.
J. C Penney Co., Inc
Phelps Dodge Corp
Procter and Gamble Co
Pullman Co.
Radio Corporation of America
Real Silk Hosiery Mills, Inc
Reynolds Tobacco Co.
Scott Paper Co
Sears, Roebuck and Co
Sherwin Williams Co.
Singer Sewing Machine Manufacturing Co.
Standard Brands, Inc.
Standard Oil Co of California
Standard Oil Co of Ohio
Timken Roller Bearing Co
Underwood Elliott Fisher Co.
Union Bag and Paper Corp
United Fruit
United Shoe Machinery Corp.
Walgreen Co
Wesson Oil and Snowdrift
Westinghouse Air Brake
Westinghouse Electric and Manufacturing Co
(Wm.) Wrigley, Jr Co
Yale and Towne Manufacturing Co

Objection to Industrial Bonds

Most of the companies whose names appear in this table are in the class known as industrials—manufacturing, trading, mining, and shipping companies. Objection may be made to our method of proving the unpopularity of bond financing by reference to the practice of experienced and intelligent management, that we have selected only industrial bonds to support our contention, and that industrial bonds have never been popular with the investor The basis of objections to industrial bonds, as compared with railroad bonds, were summarized long ago by one of the authors as follows

1. The demand for any manufactured product is less stable than the demand for railway transportation in the same territory.
2. Manufacturing companies are more exposed to competition
3. The location of manufacturing industry is subject to more frequent changes
4. The personal equation enters more largely into the management of a manufacturing company than into railway management.
5. Manufacturing industry is more complex, less visible, and therefore less easily understood by the investor than the business of railway transportation [7]

An additional obstacle to the marketing of industrial bonds is the fact that, aside from insurance companies, such bonds have never been legal investments for trust funds.

This opinion of industrial bonds has prevailed until the recent depression It was not easy to sell the bonds of manufacturing and mining companies unless these companies, as already explained, had large visible resources of raw materials which, in some mysterious manner, were supposed to contribute to the earnings of the owning companies, although, as experience has more recently shown, they have usually represented nothing more than an opportunity to pay heavy taxes and interest on large amounts of bonds issued to acquire these assets. The comparative unpopularity of industrial bonds is shown by the amount of interest paid on such bonds, as compared with the interest paid on other classes of long-term obligations In 1930 the total amount of interest paid on

[7] *Trust Finance* (1903), p. 271

the bonds of manufacturing and mining companies was $308,000,000.[8] These figures seem small when contrasted with the $2,600,000,000 of interest paid on real estate mortgages in the same year, $579,000,000 paid on steam railroad bonds, and $533,000,000 paid on the bonds of public utility companies. Evidently, industrial bonds occupied a position of minor importance in the national investment portfolio. But was this due to a conviction among investors of the constitutional inferiority of such bonds, or to the unwillingness of large and prosperous industrial companies to raise new capital by issuing obligations? It is impossible to dogmatize on this point because direct evidence is not available. We are not privileged to listen to the discussions of financial policy in the board rooms of General Motors, Du Pont and Allied Chemical and Dye. Any conclusion which we may draw as to the reasons for this refusal to borrow must rest upon inferential evidence.

In the first place, there is no doubt that bonds could be sold by industrial companies, because they have been sold in very large amounts. The steel, oil-refining, department store, coal-mining, railway equipment and rubber companies, among others, have borrowed large sums of money. When possible, as already remarked, they paid off or drastically reduced these bonds, but they were successful in selling bonds at reasonable rates of interest but little higher than those paid on any but the best grade of railroad and utility bonds. Even in the twenties, the investor had come to recognize that the real security of bonds is not property, but the income produced from property, and the incomes of these large industrial companies would have supported an interest many times greater than the $308,000,000 which represented the highest aggregate amount of industrial bond interest.

Taking the total disbursements to investors in 1930 by all the industrial corporations whose stocks were listed on the New York Stock Exchange in May, 1937, we find that this amount was about $2,238,500,000. Assuming that one-third of this amount of distributed income could have been safely represented by bond interest, and capitalizing this amount at 6 per cent, higher than the rate paid by most first-class bonds, the total amount of bonds which could have been supported by the industrial corporations listed on the Stock Exchange would have been in excess of $12,436,100,000. As a matter of fact, the total amount of in-

[8] Kuvin, Leonard, National Industrial Conference Board, Inc., "Private Long Term Debt and Interest in the United States," p. 44.

dustrial bonds, based on a capitalization of the interest paid, is $5,133,-333,400. Mr Kuvin's estimate of interest charges paid by different classes of corporations included all corporations and was not limited to those listed on the New York Stock Exchange While these, of course, pay out most of the investment income, still the comparison between Mr. Kuvin's figures and those obtained from the companies listed on the New York Stock Exchange is favorable to the latter.

We may safely conclude that industrial corporations did not keep down their debt to this comparatively low figure from necessity, but rather from choice Their refusal to borrow was not due to the unwillingness of investors to purchase their bonds, but to a settled conviction on the part of their managements that bond financing was not wise. This is shown by other evidence, already alluded to.

It is the general experience of all industrial borrowing that where profits and values permit, bonds, when issued (and this usually takes place during a period of emergency) are retired much more rapidly than the sinking fund contracts require The most conspicuous illustration of this policy was the payment in 1929 by the United States Steel Corporation of $271,462,000 of bonds, in part out of cash resources, and in part by the sale of a large amount of common stock at $140 a share Mr Myron Taylor, Chairman of the Board, in explaining this action, said in effect it is a wise thing for a man or a corporation, when able to do so, to pay off its debt By so doing, it not only improves its current position, but it opens the way to contract new loans should occasion require Mr Taylor, in his last report as chairman, made the following comment on this repayment

"In 1929, the financial structure of the corporation was materially changed through the redemption of the mortgage bonds of the corporation to the value of $340,000,000 . That transaction relieved the corporation of a charge of about $31,000,000 a year *It is fortunately not necessary to speculate as to what would be the condition of the corporation to-day, had it been required to pay this heavy interest charge during the depression years* " [The italics are ours]

Dewing, in the last edition of his work on *Financial Policy of Corporations,* Chapter 12, p 491, after advocating judicious borrowing, makes the following comment.

These observations are true But they comprise a criticism, only if there are no compensating advantages that outweigh the greater cost The chief is the unquestionable stability in which it places the corporation, the independence of all fluctuations in the demand and supply of money, and *the possession of large cash reserves to purchase raw materials and to make advances to the producers of raw materials* [The italics are ours] The depression of the following years with its tightened credit conditions found corporations which had followed this policy (mainly stock sales) in an impregnable credit position, their ability to withstand inventory losses and frozen merchandize credits, and a partial and often complete paralysis of demand for their products, attested to its wisdom The somewhat higher cost of financing through stock sales rather than through borrowings was the price of almost negligible importance, which such corporations paid for this compact financial structure and impregnable credit position

Borrowing and the Public

We believe that we have submitted sufficient evidence and authority in support of the conclusion that the settled policy of well-managed industrial corporations which produce most of the investment income in the United States, is opposed to long-term borrowing However, the case against long-term borrowing is not yet complete. It is not sufficient to show that corporate managements and bankers follow a given course of action. It is necessary, therefore, to consider, aside from the practice of corporation managements, the effect of debt upon the economic life of the United States. The corporation, as an institution, is set up and maintained by the public authority as an instrument for the performance of indispensable economic functions These are as follows

1 To produce goods and services
2. To purchase materials.
3 To employ labor.
4. To pay taxes.
5. To furnish a return to those investors whose contributions originally set up and equipped these corporate structures

The fulfilment of each one of these purposes is socially desirable If the managements of the companies carry on their operations with reasonable facility and smoothness, if their production and sales are well maintained, if their bills are promptly collected, if their working forces are maintained at full strength, if their plants are well maintained and

enlarged to keep pace with growing demand, if their operations are profitable, so that their payments to investors can be promptly made, and if they can pay their taxes, then we have the condition known as prosperity If, however, due to the non-fulfilment of these conditions, the flow of income through the treasuries of these corporations, throughout the various channels of trade and back into the treasuries of the corporations, is in any considerable degree interrupted, if the channels of circulation are blocked, so that the flow of income is retarded or reduced, then we have the condition, socially disastrous, which we know as depression.

In order to consider the social justification of a given capital policy—for example, the policy of borrowing—we have to answer this question What effects do the latent consequences of the borrowing policy have upon the objectives of corporation activity? Do they further these objectives, or do they hinder and defeat them?

Default and the Public Welfare

It needs no extended discussion to show that corporate default, which is always latent in corporate borrowing, operates directly against the welfare of any corporation which is unfortunate enough to become involved in bankruptcy or reorganization proceedings Long before the default occurs, its probability is recognized The management immediately begins to take steps, often bearing the appearance of desperation They stop all new construction, they curtail purchases, they abolish research, they reduce salaries and wages wherever union contracts do not interfere, they consume existing inventories and reduce their purchases to the lowest possible level, they sharply curtail renewals and maintenance charges In 1933, for example, one of the leading railway companies of the United States, which narrowly escaped default, did no painting on any of its structures If the company is a national advertiser it sharply reduces its advertising expenditures In every available way, it conserves its cash, in order, if possible, to meet its fixed charges There is no way in which these charges can be reduced They must be met and to meet them, as sales and profits decline, it is necessary to reduce expenses.

If this course of events is confined to corporations in a single industry, or to several industries, the national welfare is not seriously involved, although so far as these corporations themselves are concerned, the

results are very damaging. During the twenties, for example, the leather industry, the fertilizer industry, the soft-coal industry, and the street-railway industry fell on evil days. Many companies operating in these industries went into bankruptcy and were reorganized. The combined effect was not sufficient seriously to interfere with the prosperity of the Coolidge era. When the latent weaknesses which lurk in many industries are brought to light suddenly by a business depression, when the accumulation of defaults spreads the miasma of fear throughout the entire population and causes wholesale curtailment of expenditures, not only by companies but by individuals, we have a repetition of the experience of 1931 to 1933. With or without a panic (this depression ended with a panic, most depressions began with such a disaster), the effect is the same.

In 1929, with a national income of $81,000,000,000, the United States was reasonably solvent Unemployment was at the irreducible minimum. Business men as a class were making money Most leading corporations were paying interest, rentals, dividends, and taxes. By 1933, however, while interest charges had gone down only from 4 8 billions to 4 3 billions, a reduction of about 11 per cent, the national income had declined 51 per cent No one may gainsay the severity of conditions in 1933, nor can the inevitable conclusion that the large volume of debt, with its fixed amount of interest in dollars, severely aggravated conditions at that time, be avoided

From the standpoint of public interest, private debt, with its periodic breakdowns into industrial depressions, must be considered as an evil We are not called upon to discuss the philosophy of public debt Concerning the necessity of this, opposite opinions may be strongly upheld. Little can be said, however, in defense of private corporate debt, from the standpoint of the public welfare.

When we consider the bearing of a large debt structure upon the corporation itself, we are on even surer ground A company which has a large percentage of bonds in its capital structure must recognize that its total costs of production are increased by the amount of interest on these bonds If the bonds carry a compulsory sinking fund, the amount of this payment must be added to the interest These charges are continually draining away the income of the business. There is no escape from them No matter what dangers of obsolescence may confront the management, demanding large expenditures for renewals, no matter how

serious may be the threat of the actuality of business depression; no matter how threatening may be the imminence of labor disturbance or confiscatory schemes of taxation or rate reduction—such situations arise in the life of every corporation demanding the withholding of profits from distribution, the conservation of liquid resources, and the piling up of cash balances To the extent that a company is burdened with fixed charges, to that extent is the necessary conservation of liquid resources interfered with. Quarter by quarter, year by year, the drain of interest continues It is reduced only by the cancellations through the operation of the sinking fund.

Experience has shown that in those industries which rely mainly upon bonds to finance their capital requirements, steam railroads, light and power companies, and real estate, the total amount of debt usually gains upon the sinking fund cancellations.

Industrial bonds were issued by a limited number of groups which, with two exceptions—steel and oil—were not particularly prosperous during this period, and the burden of interest charges was on this account severe Other issues of industrial bonds were made by department stores, bituminous coal mining companies, textile and meat-packing companies Most of the industrial groups which showed large profits had no bond issues.

The managers of these numerous prosperous industrial companies which did not borrow have had abundant reason to congratulate themselves During the depression there was a veritable slaughter of bondholders. In default were $10,000,000,000 real estate mortgage bonds and $2,000,000,000 farm-mortgage bonds. That the street-railroad bonds were not defaulted on a large scale was due to the fact that they had already passed through this experience and disappeared shortly after the War The financial history of American corporations from 1931 to 1935 furnishes a conclusive refutation of the theory that it is wise and prudent to borrow money in order to make money Large-scale borrowing of money, unless conducted with the very greatest circumspection, involves the probability of disaster

The advocates of borrowing qualify their opinion of this hazardous practice in capital structure building by the statement that borrowing is advantageous if the fixed charges on debt are kept well within the minimum net earnings which are indicated by the experience of the corporation. In this way they save themselves from criticism They ap-

prove large-scale borrowing. When asked to explain the disaster resulting from large-scale borrowing they reply "Ah, yes, in these cases the rules of sound financing were violated Too much debt was incurred."

It is difficult to follow with any measure of approval such twisted reasoning Perhaps an analogy may serve to illustrate our point. Alcohol is a poison. Under some circumstances, such as prolonged exposure to cold or a severe shock from an operation or injury, strong drink may be beneficially administered. So in the field of corporation finance An emergency sometimes arises when large sums of money must be raised and when money can only be raised by borrowing on mortgage or collateral security Under these circumstances, there is no alternative The company must borrow. Under these circumstances, companies do borrow If well managed, however, as soon as the emergency is past and their earning power is again reestablished, they pay off the debt as rapidly as possible. To admit the necessity of borrowing under these circumstances, is very far from approving borrowing as a settled policy How is it possible to determine the limits of conservative borrowing—the amount of debt which the company can incur without danger? The light of experience is not sufficient. Measured by every then accepted standard of safety, the large railway companies, many of which defaulted during the last depression, and some of which, while surviving, narrowly escaped default, had not borrowed too heavily. The securities of many of the railway companies now in bankruptcy, during the twenties had qualified as legal investments under the laws of New York, that is, they had earned 1½ times their fixed charges for the last six fiscal years and for the last year. In some cases among these bankrupt railroads—for example, the Chicago and Northwestern—their margin of safety was well above the New York standard Even the most conservative advocate of the practice of trading on the equity could have found no fault with such borrowing. It was well within the accepted limits of safety based on long experience. Yet these companies are bankrupt, and when their reorganizations are completed there will be little left for their bondholders.

A conservative estimate of earning power to determine "safe" amounts of fixed charges in this day of rapid change among these constantly recurring waves of obsolescence is impossible to formulate The only safe course is that taken by such companies as the General Electric, Du Pont, and Allied Chemical and Dye—not to borrow at all

Then, when depression comes, and in common with all business units, they suffer a reduction in the demand for their product, they are obliged to curtail their operations, to reduce their working force, or it may be to cut their dividends or even to suspend them altogether, yet they are certain to survive and function, if not on their normal scale, in their normal manner.

CHAPTER 18

METHODS OF PAYING FOR STOCK

Full-Paid and Assessable Stock

The final step in launching the corporation is to provide the money. As we have seen in a previous chapter, most corporations start with only one class of securities, common stock This stock must now be paid for Several forms of consideration for the payment of stock are available The necessary amount of stock has been authorized The certificates have been engraved or printed and are in the possession of the officers of the company. This stock, from the standpoint of the method of payment, is divided into two classes. assessable stock and full-paid stock Assessable stock is paid for when and if calls for payment are made on the stockholders by the directors. The share certificates are issued when the first assessment is paid With full-paid and non-assessable stock, the certificates are only issued after the entire subscription price has been paid The latter is the usual form. A typical assessable stock subscription is as follows On $10,000 of stock, par value $100, $1,000 will be paid in cash and $9,000 in a promise to pay that amount when called for by the Board of Directors This promise to pay is in writing It appears in the certificate and also in the subscription agreement, to which reference will presently be made The advantages of this form of stock, viewed from the standpoint of the corporation, are considerable. The issue of assessable stock makes it possible for a new company to guard against underestimates of the cost of construction and development If the cost of a plant, plus the expense of establishing a business as a going concern, plus working capital, is estimated at $500,000, and if $500,000 is secured from the stockholders by the sale of stock paid in full, and then, if the amount required to launch the business is raised by unforeseen delays or increases in the cost of machinery or materials to $750,000, the directors must obtain this money either from the stockholders or by borrowing It is difficult under such conditions to persuade stockholders to buy an additional amount of common stock The company has started out with

a confessed mistake The directors' estimates are admittedly wrong. Stockholders are likely to lose confidence at the outset in the management which is responsible for the mistakes in the estimates, and may even oust the directors from office.

Advantage of Assessable Stock

A banker interested in promoting a furnace enterprise in Pennsylvania remarked to one of the writers that it was easier to procure $2,000,000 at the outset than to procure an extra $200,000 after $1,000,000 had been represented as all that would be necessary. Furthermore, in the development of some industries—gold mining is the most familiar example—it is impossible to accurately forecast the exact amount of money which will be needed. Gold is where you find it, and the veins of gold are apt to "pinch out" after the extraction plant has been erected It is then necessary to do an additional amount of development work if the enterprise is to go forward If the original issue of stock was fully paid and non-assessable, and if additional funds are necessary, the directors may be required to issue preferred stock to the limited number of stockholders who are willing to continue their support, or even to issue bonds in the early stages of the enterprise, which they would otherwise not do

This obstacle to the development of the new company may be removed in advance by the issue of assessable stock. If additional funds are needed, the directors make calls up to the unpaid balance of the par or stated value, and the stockholders are forced to respond. If they do not respond to the call, the directors may sell so much of the stock of non-responding owners as may be necessary to meet the call. When and if the sale of the entire holdings of the non-responding stockholders does not provide enough to pay the amount called, the directors may then sue the stockholders for the balance It is common practice, when assessable stock is issued, for directors to informally assure the stockholders against unreasonable calls, but they are under no legal liability to carry out these understandings, unless, in the subscription agreement, it has been specifically provided that no more than a certain percentage of the unpaid balance of the stock will be called in any specified period of time.

The correct method of accounting for the unpaid balance of assessable stock is to carry it as an asset on the balance sheet under some appropriate title, such as, "Calls Receivable." This balance of unpaid subscrip-

tions is, in a very real sense, a liquid asset of the company. It consists of promises to pay the balance due on his shares by each stockholder, according to the number of shares which he owns. He must pay this, in the absence of some stipulation to the contrary in the certificates, whenever the directors call it This promise, moreover, is secured by the stockholder's interest in the corporation for whatever it may be worth, and by the net worth of the stockholder The security can be turned into cash by selling all or part of the holdings of each stockholder who fails to respond to the directors' call.

Assessable stock, with all its advantages from the standpoint of the company, is unpopular with the purchasers of stock. Any placement of funds in a new business is a speculation surrounded by many hazards. If to the normal risks of business is added the indefinite and uncertain prospects of a call for additional capital, the American stockholder, at least outside of special classes of business, such as banks or gold-mining enterprises, is reluctant to purchase such stock In England, the use of assessable stock is common, but in the United States, in the general run of corporations, it is not met with.

Example of a Subscription Agreement

When, therefore, stock is to be sold, it is usually necessary to make it full paid and non-assessable, these words appearing in the stock certificate. The first stage in paying for stock is to secure an agreement from the prospective stockholder, in the form of a subscription agreement, that he will buy the stock. A form of subscription agreement is as follows

We, the undersigned, severally subscribe for and agree to take and pay for the number of shares set opposite our names, respectively, of the capital stock of the Walter A Wood Harvester Company (being the same corporation formerly known as the Minneapolis Harvester Works), of the par value of one hundred dollars each.

These subscriptions shall become binding as soon as stock in the said company to the amount of $1,500,000 at par value shall have been subscribed for.... The payment of subscriptions shall be made in installments as called for by the board of directors of said company, and at such times as said board shall direct, provided that not more than fifty per cent thereof shall be called for or be payable within one year from the first day of January, A D, 19—.[1]

[1] Ballantine, *Private Corporations* (Callaghan and Company, Chicago, 1927), p. 109.

This agreement is a contract between the corporation and the subscriber, and the corporation has the right to sue under it. There is no way in which the subscriber, when he has signed such an agreement, can escape his liability, unless he can prove in defense of a suit brought against him by the corporation, that his signature was procured by misrepresentation. The misrepresentation must be a material misstatement of fact, and must have been made by the corporation As a matter of convenience to the subscriber, it is common to stipulate in the subscription agreement, for instalment payments, the money to be paid in as the company requires it for the construction of its plant. For the protection of the subscriber, as well as the corporation, the dates and amounts of the instalments are set out in the subscription agreement Failure to meet an instalment renders the subscriber liable Furthermore, until all the instalments have been paid, the subscriber has no right to receive dividends Neither does he have the right to receive a certificate of stock in the company. Instead, he is given a receipt for the money paid. It is customary to pay him a low rate of interest on the money which he has paid in, in lieu of dividends. Although the subscriber does not become a stockholder until he has paid for his stock in full, yet in the event of bankruptcy of the company, these unpaid portions of subscription contracts are assets of the bankrupt company, and the Trustee in Bankruptcy or the Receiver may sue for their recovery To this extent the subscriber to instalment stock, while he can not vote or receive dividends, is liable to pay the creditors of the company the full amount of his subscription.

Considerations Acceptable in Payment for Stock

The considerations for the payment of stock are as follows cash, property actually received by the company, and services rendered or labor performed for the company The corporation laws of the various states are specific as to the consideration which may be accepted in payment for stock. For example, the law of Delaware provides as follows:

> Subscriptions to, or the purchase price of, the capital stock of any corporation organized or to be organized under any law of this state may be paid for, wholly or partly, by cash, by labor done, by personal property, or by real property or leases thereof, and the stock so issued shall be declared and taken to be fully paid stock and not liable to any further call, nor shall the holder thereof be liable for any further payments under the provisions of this chapter

The practice is, however, not to issue the stock until the contracts whose execution will constitute payment have been completely performed, and the work approved by the corporation These contracts are executory contracts, and the shares are not issued until they are executed.

A Delaware corporation, for example, can accept, in payment for its stock, cash, promoter's services which have been accepted and approved by the directors of the company, services of lawyers in the incorporating of the company, real estate or options for the purchase of real estate, or leases of titles to real estate assigned to the company, or easements in real estate and franchises (that is, rights to use public property for private profit).

Services *to be performed* are not valid considerations for the payment of stock subscriptions. When it is desired to enlist the services of some experienced executive, perhaps to draw him from his present employment by the promise not only of a high salary, but of an interest in the business, the stock part of his compensation is paid him either by offsetting the bills for these services as instalments on the stock to be issued to him, or by issuing to him at regular intervals shares of stock in payment for services already performed Another method of compensation with stock is to give the executive rights to subscribe to stock at a low figure, in the expectation that he will be inspired by the prospect of profit to greater diligence in the service of the corporation

Property consideration for the issue of full-paid stock is usual. The most common form is the transfer of options to purchase real estate or patents The corporation issues stock for the option and then performs the conditions of the option and so gains title to the property.

The Problem of Overvaluation of Consideration

When real estate or patents are used as consideration for the issue of stock, they need not be accepted at their *cash* value In accepting executory contracts for services or conveyance of title to property in payment for stock of the company, the important consideration is the value *to the corporation* of the property or services performed The laws are specific upon this point The company must receive full value for the stock which it issues If the stock has par value, the property or services must be equal to the total par value of the stock paid for. If the company has issued no par stock, the directors or the stockholders must, by formal

action, place a value upon the stock which is issued for any form of consideration The law of Pennsylvania upon this point is as follows

Subscriptions for shares having a par value shall be made . . . with consideration other than money, the fair value of which to the corporation is not less than the aggregate par value of the shares subscribed for Subscriptions for shares having no par value which are made before incorporation shall be made payable with consideration of the character and value determined by the incorporators. Subscriptions for shares having no par value, which are made after incorporation, shall be made payable with consideration of the character and value determined by the shareholders at any annual or special meeting duly called and held for that purpose, or determined by the Board of Directors, acting under authority conferred by the shareholders or in the articles of incorporation.

The problem of overvaluation in terms of capital stock for property or services purchased by the corporation does not arise so long as the company remains solvent If the stockholders approve the purchase of $100,000 of property with $1,000,000 par value of stock, that is their business, so far as their relationship to the corporation is concerned. If, however, the company becomes financially embarrassed, is unable to pay its debts, and either files a petition in bankruptcy or is petitioned into involuntary bankruptcy by its creditors, then, such a transaction may involve the persons who received the stock in serious embarrassment The theory of the law is that the company must receive full value for its stock, either full par value or the full stated minimum value. This value, which may be called for want of a better term, judicial value, is different from market value in cash. It is the value of the property to the company, and not the price which could be obtained by a sale for cash. The payments are not made in cash, but in stock The stock may or may not prove to be valuable. The value will depend upon the earnings of the company, and upon the amount of those earnings which are paid out in dividends At the time the property is transferred, the ability of the corporation to earn, and its willingness to pay, have not yet been demonstrated. The profits in which the holders of this stock are to share are not yet realized. Any one who transfers property, or contracts to perform services in exchange for stock, can properly charge much higher prices than if he were to receive cash. The corporation, on its part, is warranted in paying higher prices, expressed in terms of stock, than if cash is to be paid for property or services. When the vendors of

property, or contractors who have agreed to perform work, will accept, instead of cash, which the company might have difficulty in securing, its stock, which it can print subject to the provisions of the incorporation law, they are entitled to liberal terms The test is the *honest judgment* of the directors as to the value of the property or services to the company How much may the company be expected to earn by the possession of this property or by the use of these services?

For example, there is in eastern Pennsylvania, a large bank of fine coal for which the mining company has not been able to find a market This bank of coal is spread over 60 acres and contains an estimated amount of 3,500,000 tons In order to develop this enterprise, it may be necessary to acquire the land at the end of the bank Through this small tract of barren mountain land runs a stream which can be used to convey the coal to an extraction plant. Without the possession of this land it will be more costly to work the bank The land, *qua* land, is worth nothing, but as the site for a recovery plant from which presumably large profits can be made, it is very valuable A company organized to recover this coal would be warranted in paying $100,000 in stock, although the land, aside from the business opportunity which it controls, is worthless If the legitimacy of this price were ever called in question, the directors would have no difficulty in establishing the value of $100,000.

The Penalties of Overvaluation

The danger of overvaluation is, however, always latent, and may become active in the event of bankruptcy proceedings. The stipulation that a company should receive full value for its stock is inserted in the corporation laws for the protection of the creditors Creditors have a right to assume that stock has been fully paid. When they advance money or property to the company in return for its obligations, this property, at a reasonable value, stands back of the company's promises to pay. This is the trust-fund theory of stock value If the company falls into bankruptcy, and if it is determined by the trustee that the directors paid $1,000,000 in stock for property which was worth to the company no more than $100,000, the condition of legal overvaluation is present, and those persons who have received the stock in payment for property at this excessive valuation, may be compelled to pay, if they are able to pay, such part of the excess value as may be necessary to pay the debts

of the company. Up to the amount of the deficiency on each share, and up to the debts of the company, every shareholder who is able to pay, must pay. The measure of this overvaluation is the difference between the fair value of the property, determined by judicial appraisal, and the total par value or the total stated minimum established by the stockholders or the directors, and the price fixed by the directors at which the stock was issued for the property. This excess value is considered to be an asset of the company in the form of a claim against stockholders who have benefited by "fraud" upon the corporation and its creditors. The court presumes from the extent of the overissue of stock, that the issue was fraudulent

This liability of the stockholders to the trustee in bankruptcy for overissue of stock applies only when those who have received the stock have continued to own it. If such stockholders, anticipating such an outcome of their conspiracy to defraud the company, which is what the courts call it, or, for more honest reasons, have taken the precaution, before the company becomes embarrassed, to sell or give away their stock, and if they have recorded the transfer upon the books of the company, so that a new set of owners have taken their places, then, they usually go free, because conspiracy to defraud is very difficult to prove, and the court is not likely to go beyond the record It should be noted, however, that these transfers must be *bona fide* transfers for a consideration, or *bona fide* gifts to those who are entitled to receive gifts, and that those who originally received the stock must have completely divested themselves of all interest in it

The final form of consideration for the issue of stock is the issue of stock for debt In a previous chapter, this method was explained in discussing convertible bonds. Another form of stock issued for debt, which will be developed at length in a later chapter, is the exchange of stock for debt in reorganizations. In the initial issue of stock, occasions may arise when it is advantageous to clear off encumbrances on property by the issue of stock or to meet contractors' or attorney's claims when cash is not available

The late Francis Lynde Stetson, who left a fortune estimated at $20,000,000, is understood to have accumulated most of it by accepting stock in various flotations and consolidations as payment of his fees Of course, the fees paid in stock were much greater than if the companies had paid them in cash. One of the large construction companies, no

longer active in this field, accumulated a very large stock interest in certain hotel companies, in exchange for its services in erecting the hotel buildings The legality of such stock issues, when it does not exceed the fair value of the services rendered or the claims submitted, is not to be questioned Of course, the same rule as explained in an earlier paragraph, applies If an excessive value is placed upon these claims, debts, or services, the recipients of the stock may be embarrassed by creditors' suits, in the event of bankruptcy

CHAPTER 19

THE EFFECT OF CAPITALIZATION UPON RATES AND PRICES

The capitalization of a company is the par value or stated value of its stock, plus the par value of its long-term debt. It is unusual to include current liabilities in capitalization For many years the Federal Congress, the state legislatures, and the various regulatory bodies which deal with the subject, have considered the effect of over- or excess-capitalization upon public welfare. Many attempts have been made to limit the amount of bonds plus capital stock which a company should be allowed to issue, as compared with the determined value of their property or assets In the early days of the United States Steel Corporation, before it emerged from the state of sin into the state of grace, the halls of Congress resounded with denunciations of the overcapitalization of this great "octopus" The claim was repeatedly made, although denied by the friends of the company, that $500,000,000 of overcapitalization existed in its capital structure, that its entire common stock represented fictitious value, *in other words*, that all of the assets of the company, on any reasonable valuation, were $500,000,000 less than the par value of its stock and bonds.

The same claims have been more recently made in the public utility controversy, which is not yet concluded, that the promoters of some public utility holding companies, at the time they arranged to purchase a controlling interest in an operating company, fixed a price for the stock of the operating company, payable in securities of the holding company, so far in excess of the original cost of the assets controlled by the operating company, that gross overvaluation and overcapitalization emerged.

The theory underlying these criticisms and attacks may be stated as follows A company is organized to pay dividends on its stock. From the viewpoint of those directly interested in it, that is its basic purpose These dividends must be paid out of profits. Profits are the result of multiplying the number of units of a product or service which are sold,

by the price at which they are sold, less the cost of production and distribution. The higher the price, in case the price is not fixed above the point of maximum net return, that is, not fixed so high as to discourage consumption, the larger will be the profits and dividends. Common usage and established custom, however, are opposed to the payment of excessive dividend rates. It is unusual to find a dividend rate of more than 6 per cent. If, however, the number of shares can be fixed at a high enough figure, the payment of the 6 per cent rate on the par value of the stock actually issued may be a much higher rate of return on the fair value of the property of the company.

In the field of industrial capitalization where the inflation of stock and also bonds in the capital set-ups was often extreme, the charge was often made that prices were fixed by the managements of these companies at figures high enough to pay dividends on their watered stock, and, by implication, that if the stock had not been issued in excessive amounts, the prices of silk, sugar, biscuits, salt, etc., would have been fixed at a much lower figure. In other words, it has been claimed by those who discussed the subject from the viewpoint of the public welfare, that the consumer has paid, in higher prices for the necessities of life, the money which was necessary to pay dividends on watered stock.

Relation Between Capitalization and Prices

This claim that overcapitalization leads to higher prices, so far as unregulated companies, that is, companies outside the public utility field, are concerned, is unsound. Every business concern, no matter on what basis it has been capitalized, fixes its prices at the point of largest return. A corporation is not in business for the benefit of its customers, but for its own benefit. Its prices are not fixed according to what the buyer would prefer to pay, but are based upon what he can be made to pay. If a corporation has a monopoly of a product, it will fix its price at the point of maximum net return, i.e., at that point where, account being taken of the larger consumption at low prices, and the decreased cost of production with larger output, and, on the other hand, of the decreased cost of distributing a smaller output, and the higher prices at which a reduced output can be sold, the net return will be the largest. If the corporation has competitors, its prices will be influenced by the quotations of its rivals. In no case will lower prices be charged than the self-interest of the seller directs.

The fallacy that the natural tendency of business men is to charge a "proper price" has dominated the argument against the capitalization of railway corporations. They have been charged with maintaining exorbitant rates in order to pay dividends on watered stock, although they have always, insofar as public opinion would allow them, determined their charges by the exigencies of competition, and by the principle of charging what the traffic will bear, the rates and prices which will produce the largest profits in traffic movement The pressure for dividends has sometimes influenced a board of directors to take undue advantage of a temporary opportunity to exact high prices or high rates, but if prices or rates were higher than the traffic would bear, the effect of such extortion was to reduce the profits of the corporation below the figure at which more moderate charges would have placed them

The "watering" of stocks and bonds by overissuing securities above the value of the corporation property, based on the earnings of the company which owns and operates the property, has nothing to do with fixing the schedule of charges upon which the revenues depend The number of pieces of paper representing the ownership of a steel corporation, and which entitle their holders to share pro rata in any disbursements of profits which the directors may make, has no more to do with the price of steel rails or steel billets, than the number of persons among whom those pieces of paper may be divided. Both steel and oil are sold for the prices which will produce the maximum profit, and there is no more reason why that price should advance because the capital is increased than that the capital should decrease because the price is reduced The same charge is made against the corporation profits tax—that the producer or dealer is forced to add the amount of the tax to his price, thus shifting its burden to the consumer. On the contrary, the seller charges the most profitable price he can obtain, tax or no tax.

Incidence of the Corporation Tax

The corporation tax, a 24 per cent charge on normal-tax net income in excess of $39,000, rests finally where it is first paid. The consumer pays no part of it, since, if the taxpaying corporation had been able to charge higher prices, and if those higher prices had produced more revenue, the higher prices would have been charged irrespective of the tax. Taxes paid by public utility companies (aside

from income taxes) restricted in their earnings by law to a fixed return on their investment may, under some conditions, be shifted to the consumer, because the legal return is calculated after these taxes are deducted, along with operating expenses from gross earnings. For example, the Consolidated Edison Company of New York, Inc., paid over $54,000,000 in taxes in 1939 and received a gross income of $56,000,000, equal to 4 1 per cent on total assets If these taxes were to be remitted, the price of gas must be reduced because the return would then rise above the legal maximum The taxes charged as part of the operation costs of the company ($54,000,000) amounted to 28 per cent of the operating expenses of the business It is clear therefore that taxes, other than the income tax, paid by the utility corporation, add a substantial amount to the price which the consumer must pay for the product.

Capitalization and Competition

The claim that the existence of watered stock stimulates competition has stronger authority to support it Thus *The Wall Street Journal* said in 1901, of the effect of the alleged overcapitalization of the United States Steel Corporation

Any plant which is overcapitalized and which pays dividends on overcapitalization, invites competition by announcing that a competitor capitalizing his plant at its true value can earn dividends If there is overcapitalization, there is certain to be competition. . . It is an economic law that profits in any line of business will not continue to exceed a fair return on the capital invested in the plant.

Here it is claimed that the competitors of the United States Steel Corporation were encouraged to press forward, by the belief that the sum of the figures set out on the faces of the shares and bonds of that company represented an amount in excess of its investment value

Within limits, this opinion is well founded An excessive capitalization on which dividends are being paid is certainly a protection to outside companies Upon this subject, some remarks of the *Iron Age,* also in connection with the formation of the Steel Corporation are of interest

Probably none have greater occasion to rejoice at the turn which affairs have taken than the outside interests. The majority of the latter express themselves as well pleased with the formation of the great consolidation

Above all, they hold that a less aggressive policy will be pursued than has characterized some of the constituent interests, and that they will be gainers from the greater steadiness which is sure to characterize the markets. They frankly admit, too, that they see increased safety to their own interests in the fact that the corporation must provide for large fixed charges and will probably make efforts to earn a good return on that part of their capital which they pronounce "water" That means that living prices must be maintained—prices which will give them an opportunity to make a profit on their own investments

In other words, the large capital of the Steel Corporation, in the opinion of its competitors, might influence its managers to a more pacific and conciliatory policy than was formerly pursued, for example, by the Carnegie Steel Company, and would render them less ready to resent outside invasion of their territory The policy of the corporation shows that this expectation was well founded, and has probably influenced the competitors of the Steel Corporation to increase their productive capacity more rapidly than they would otherwise have done.

Indications have not been lacking of more sinister influences of overcapitalization. In an endeavor to market their stock, the men temporarily in control of certain corporations have marked up prices of company products to excessive figures, and have given large encouragement to competitors Charges have also been made that many plants have been built for the purpose of selling them out to some company which was endeavoring to retain control of a particular industry These two variants from established business practice may, perhaps, be cited as further evidence that overcapitalization stimulates competition.

But while so much may be conceded to the theory that overcapitalization stimulates competition, it is only one of a number of factors considered when a new and competing enterprise is proposed. A man engages in a business because he sees an opportunity to make a profit by producing or buying commodities at one price or cost and selling them at a higher price He does not look solely to the capitalization or the dividends of his competitors when forming a final judgment as to the profit of an enterprise. Large dividends on large capital may call his attention to the profits of an industry, but the factors determining a change in his investment are the conditions of the industry and the prospects of the market

A group of men proposing to engage in the manufacture of steel, for

example, would take into account the following factors (1) the supply and cost of raw material, (2) cost of labor, (3) the construction cost, (4) the transportation rates, and (5) the prospective demand for steel. They would next turn their attention to the position of the manufacturers already in the field, and here the capitalization of competitors would be considered. But the decisive considerations which influence any scheme for building competing plants, are the cost of production and the demand for the product. The dividends of competitors are not to be relied on as a guide to profits. These may be concealed or exaggerated. The foundation of conservative judgment consists of the known facts of the industry.

Overcapitalization and the Issue of Worthless Securities

The third objection to the method of capitalizing a corporation on the basis of estimated earnings, instead of investment or cost of replacement, is founded on the claim that such capitalization leads to the issue of large amounts of worthless securities. We may admit that the method of capitalizing earnings generally employed in the United States has, in the days that we hope are gone forever, resulted in deluging the speculative public with the stocks and bonds of new enterprises whose prospective earnings are seldom realized. The evils resulting from these practices are generally recognized and deplored. It must be admitted, also, that the enforcement of a law which would limit the issue of capital to the amount actually invested in an enterprise would have the effect of banishing from the stock exchanges low-priced, speculative securities.

Overcapitalization and Public Service Corporation Charges

In the field of public service corporations—railroads, street railroads, gas, and water companies—the alleged evils of overcapitalization are most serious. The organs and instructors of the public have labored to fix in the minds of the voters the conviction that the overcapitalization of a public service corporation results in a tax upon the patrons of the monopoly to pay interest and dividends on the watered capital. Even if the advocates of this view admit that a railroad or a street railroad company, no matter what their capitalization, will make all they can out of their business, and will only regard their debt or the number of shares of their capital stock when they come to divide their gains,

the critics of overcapitalization still contend that, by multiplying bonds and stocks, these companies are able to conceal their earnings, to keep the public in ignorance of what they are making, and in this way, to safeguard their ill-gotten gains

It is true that in many instances the stock or bonds of a company have been increased in order to keep the public in ignorance of its real earnings, or to invoke the aid of the law against proposed reductions of rates or charges, on the ground that the enforcement of the new tariffs would result in injury to the innocent investor. This has been particularly true of street-railway and gas companies, where uniform charges invite a horizontal reduction of rates by the legislature Excessive capitalization as a protective device against legislative interference is, at best, however, a recourse of doubtful value. If, in the opinion of the court, the public policy demands a reduction of charges, the bondholder will have to take the consequences

A holder of stock in the American Sugar Refining Company could not successfully plead his "vested interest" in opposition to a proposal to reduce the tariff on sugar, nor could a holder of People's Gas of Chicago, or Public Service of New Jersey stock have much hope of success in a plea against a reduction of his dividends by some act of the municipal legislature. As a rule, the public policy will prevail with the court While care will be taken to allow a fair return to capital, and while the court will be especially careful not to force a company into bankruptcy by approving a reduction in rates which would make the payment of interest impossible, if it came to an issue between public interest and private interest, private interest must give way

Cases Defining Reasonable Return and Fair Value

The question of the reasonableness of rates, from the point of view of the investor's interest, has been frequently raised in suits brought to restrain the reduction of rates by railroad commissions The United States Supreme Court, while admitting that the investor's rights should be considered, has gone on record as upholding the interests of the public to be paramount to any other interest. The most forcible expression of this view is contained in the opinion in the Nebraska Maximum Freight Rate case

The rights of the public would be ignored, if rates for the transportation of persons or property on a railroad are exacted without reference to the fair

value of the property used for the public, or the fair value of the services rendered, but in order simply that the corporation may meet operating expenses, pay the interest on its obligations, and declare a dividend to stockholders.

The principles underlying the regulation of the rates and prices of public service corporations have been finally settled by a line of decisions in the federal courts. These companies are entitled, irrespective of the amount of their debt or the number of shares into which their capital stock may be divided, to a "reasonable return" on the "fair value" of their property.

A leading case which illustrates and confirms this principle is that of the Chesapeake and Potomac Telephone Company of Baltimore City versus Whitman et al, Public Service Commission of Maryland[1] This case was decided by the United States District Court, D. Maryland on February 27, 1925, in favor of the company.

In June, 1924, the Chesapeake and Potomac Telephone Company of Baltimore City wished to increase its rates and, in accordance with the law, it published schedules of the proposed new rates and filed copies of them with the Public Service Commission of Maryland The contemplated new rates would have increased by over $1,100,000 or by 12½ per cent, the cost of the services then being supplied to the public. In order that the Commission should have sufficient time to inquire into the reasonableness of the proposed rates, the effective date was postponed until November 1, 1924 After extended hearings, the Commission handed down an opinion and order refusing the increased rates asked for and continued the previously existing rates in force for the succeeding two years. The company began its suit on December 31, 1924, two days after the order of the Commission was entered, claiming that, under the rates provided in the order, it could not get a fair return upon the fair and reasonable value of its property devoted to furnishing telephone service in Maryland. At the hearing, every one agreed that the company was entitled to a fair return upon the actual present value of its property employed in the service of its patrons, for, as the Supreme Court has said "Rates which are not sufficient to yield a reasonable return *on the value of the property used at the time it is being used to render the service* are unjust, unreasonable, and confiscatory, and their enforcement deprives the public utility company of

[1] *Federal Reporter*, Second Series, Vol 3, p 938

its property in violation of the Fourteenth Amendment" As usual, however, in rate cases, there was a wide difference of opinion, both as to what that value is and as to the relative accuracy of the several conceivable ways of ascertaining it Another matter in dispute was the minimum percentage of return to which the company was lawfully entitled

The Company's Valuation

The company's present fair value of its property was considered by it to be the *present reproduction* value. In ascertaining this value, it employed three experts to fix a value upon its land, and three practical builders and contractors to examine its buildings and report the cost of reproduction The valuation of other property was made independently by two persons, one a competent consulting engineer, and the other the chief engineer of the company Both engineers accepted the estimates of the real estate experts and builders as to the value of the land and buildings, to which they added the estimated values of other property. The result was that one reached a total cost of reproduction of $47,283,275, and the other a cost of $42,829,008. From the $42,829,008 estimate, which was that made by the chief engineer of the company, deductions for depreciation amounting to $4,513,855 were made, so that the present value was put at $38,315,153

The Commission's Valuation

The Commission calculated the value of the company's property as of December 31, 1923, and fixed it at $24,350,944 In reaching this total, the Commission started with $13,062,197, "the sum originally ascertained to have been on June 30, 1914, the *cost value new* [2] of the company's tangible property. To this amount it added for net additions since, not the $15,931,443, shown on the face of the books, but only $15,276,483, and thereby arrived at a cost new on December 31, 1923, of $28,338,680" The reduction of the present value of net additions was not explained, although it fixed the cost of the company's tangible property at a figure $654,960 below the cost shown by its books.

From what it found to be the cost of the company's property to the date in question, the Commission deducted for depreciation, not the $6,022,854

[2] Italics are the authors'

then outstanding to the credit of depreciation reserve, but what was in some sense, at least, the arbitrary amount of $5,667,736, or 20 per cent of each cost. In this way it arrived at the sum of $22,670,944 as the actual value of the Company's tangible property To this it added $975,000 for working capital, and $705,000 or the worth of the company's intangible property, that is to say, "going concern value," "cost of attracting business," or whatever other title you may choose to give it. The total $24,350,944 is the amount upon which the Commission says the company is entitled to a fair return.

The Court's Valuation

The method used by the court to ascertain the fair value of the property is contained in the following statement

We have, moreover, examined with care the moneys from time to time invested in the company's business Our data has been taken from the Company's balance sheets, and not from its so-called investment accounts, as the former, and not the latter, give the information needed in this connection On June 30, 1914, its balance sheet showed a total investment of $12,727,-528 It has grown year by year since, but at quite varying speeds By the use of index figures we have reduced the amount of those additions to investment, to the values of dollars of 1923, with the result that the total net investment on December 31, 1923, as expressed in the then temporary dollar, was $35,037,212, to which should be added for intangible value $1,085,700 in dollars of the same time. The total is $36,122,912.

From this figure, which represents the cost of *reproducing new* [8] the company's property as of December 31, 1923, there should be deducted for depreciation the sum of $6,614,963, and the amount upon which the company was of that date entitled to earn, if possible, a fair return, was $29,507,949.

Rate of Return

The Company says it is entitled to a return which would yield it 8 per cent on the fair present value of its property It claims that its plant is worth upwards of $38,000,000, even after allowance has been made for depreciation, 8 per cent on that sum would be $3,604,000 The rates which it would have put into force, had the commission permitted it to do so, would, it calculates, yield it a net revenue not much over two-thirds of that sum, or less than 6 per cent on what it claims to be a fair value of its property.

[8] Italics are the authors'

In deciding this point the court stated:

> We are not a rate making body. All that we decide is that the Commission may not deny the Company permission to charge rates which will produce at the minimum 6 per cent on the fair value of its property at the time used, or useful in telephone service, and that on December 31, 1923, that property was of a value of $29,507,949. To-day it is, of course, that value plus whatever net additions to it have since been made, diminished, however, by whatever net increase, if any, there has been in the unexpended balance standing to the credit of depreciation reserve.

In the Minnesota Rate Cases, the court accepted the cost of reproduction as the method of determining the fair value of the property, and applied to this a 7 per cent rate as that to which an investor in the railway business—more hazardous than the business of supplying gas in a large city—was properly entitled.

Capitalizing Reasonable Return

In neither of the cases mentioned above were the rights of the stockholders to receive a given rate of dividends on their stock regarded by the court. The stockholder has no right to dividends which can be pleaded against the public interest. The corporation, as distinct from its creditors and stockholders, has a right to a reasonable return on the fair value of its property employed in the public service. The income which represents this reasonable return, the company can divide according to its pleasure. If, for example, the fair value of a utility company's property is $100,000,000, a reasonable return might be $7,000,000. Assuming an equal division of the capitalization between stock and bonds, and that the bonds bear 4½ per cent interest, $2,250,000 would be devoted to interest and $4,750,000 to dividends, or 9½ per cent on the stock. The company might double its stock capital, raising it to $100,000,000. On this it could pay 4¾ per cent. Or, it might cut its stock capital in two, reducing it to $25,000,000, on which the dividend would be 19 per cent. This apportionment of the company's income would be no concern of the courts, although the Public Service Commission of a state might exercise authority over it, as in New York and Wisconsin, or the Interstate Commerce Commission under the Esch-Cummins Act, by which issues of capital are closely restricted. All that the Federal courts are concerned to do, however, is to protect the public

against exorbitant charges, to limit the income of public service corporations to what is fair and reasonable. Questions of capitalization, over or under, as the case may be, do not concern them

It is evident that the amount of capital liabilities is of minor importance. Companies charge those rates and prices which in their judgment will yield them the largest profits. After the profits have been made, they are distributed. Not until then does the number of shares of stock, or the number of bonds which the company has issued, become of importance to the consuming public. In the regulated industries, however, as already indicated, the overvaluation of assets may be a very serious matter to the public For those utility companies, the demand for whose product or service is expanding, which are carrying on business in a seller's market where increasing rates and prices will not reduce the demand, the question of overcapitalization is of vital importance to the public On the other hand, for those utility companies which operate in industries where the demand is declining, and where an increase in the price can not be safely made, the question of overcapitalization is of minor importance. This distinction may be illustrated by the contrast between the steam-railway and the street-railway industries, on the one hand, and the light and power industry on the other. The demand for transportation service performed by steam and street railways has been for some years declining, while the demand for electric power has been increasing.

We have already seen that public utility companies, in return for a monopoly of supplying a product or service, and for the privilege of occupying public property for private use, are limited in their profits to what the commissions or courts may decide is a reasonable return on the fair value of their property employed in the public service In no sense is this return guaranteed them by the public authorities, but they are merely allowed to charge rates and prices that will yield them profits equal to a fair return. If, now, the light and power industry can establish high valuations for their property by various devices of padding costs, which many of them have done, and if at the same time the demand for electric current is so strong that they can maintain or even increase, for example, their retail charges, the public may be required to pay rates which yield unfair and excessive profits to the utility.

On the other hand, in an industry operating in a condition of declining demand, the valuation is a matter of indifference to the public. Since

the demand is decreasing, it is impossible for the operating companies to increase their rates and prices, without doing themselves more damage. For example, at the present time, the anthracite-carrying railroads are under pressure from the coal producers, the retail dealers, and the public to lower the rates on the transportation of anthracite coal. The demand for anthracite has been declining for twelve years At the present time it is only five eighths of what it was at the peak. These railroads are not earning a reasonable return on the fair value of their property. If the rates are reduced, since the demand is declining, and since the decline has been due, not so much to the price charged, of which the freight rate is a component part, but to the competition of other fuels, it is a grave question whether the railroad shipments of anthracite will increase at all or whether, in fact, the decline in demand will not continue to reduce the traffic. In that event, a reduction in anthracite rates will inflict more damage upon these anthracite carriers, and the anthracite companies and their employees will get no substantial benefit. Any attempt to increase rates, or the price of coal, is out of the question.

CHAPTER 20

PROTECTING THE INVESTOR FROM LOSS THROUGH FRAUDULENT SECURITY ISSUES

Corporations in this country are dependent upon the public for the capital necessary to start their enterprises, and to some extent also for the capital necessary for growth or expansion. When a new enterprise is to be started, or when an existing enterprise needs additional capital, the promoters of the former and the management of the latter, invite subscriptions by the public to the stocks or bonds of the company. The response of the public to these overtures is to a large extent conditioned, first, by the nature of the appeal for funds, and second, by the intelligence or business judgment of the persons receiving the appeal. The buyer of corporate securities frequently lacks sufficient knowledge and experience to make an independent decision with respect to investments Too frequently he considers all purchases of stocks and bonds as investments. He can not distinguish between an enterprise which by nature is speculative, and one which offers an investment opportunity The new and untried opportunity, if skilfully presented, frequently appeals to him more than the established and successful business, as a source of income. The first seems to offer him a chance for great profit, while the latter will pay him but a small, though regular, return. Not knowing the extent of the chance he takes, and ignorant of the business, he buys securities for investment which often become worthless

Furthermore, where industries depend upon the public for capital, and where such a large portion of the public lacks investment experience, the door is open to the securities swindler. He has no legitimate business to be financed. He does not intend to use the proceeds of the sale of stock to purchase land, buildings, and machinery and engage in actual enterprise. He is concerned with obtaining money from the ignorant and gullible public under false pretenses. His appeal is plausibly and spectacularly presented Outwardly there is nothing to distinguish it from a legitimate offering. Something for nothing is the swindler's ambition, and fraud characterizes his sales approach.

Speculative vs. Fraudulent Securities

A distinction must be made between securities which, though highly speculative at the time of issue, are legitimate, even though they afterward become worthless; and securities which are sold with intent to deceive In the first case, the promoters or company management seek capital for a venture whose success is entirely problematic The funds obtained are used for the announced purpose, but the business does not succeed and the securities become worthless In the second case, misrepresentation is used to obtain funds which are never intended to be employed for a business purpose. Fraud has always been a crime, and the government will punish the perpetrator.

It is possible for securities to be classified as fraudulent, even though there is no intent to defraud the purchaser. The sellers of these securities may not give to the buyers at the time of issue sufficient information to disclose the risk involved in making use of the funds obtained, the sellers, in effect, misappropriate the funds, or do not apply them to the business venture to be undertaken as announced. Many of the fraudulent security issues of recent years have been of this type—not deliberate frauds, as indicated above, but fraudulent, due to the fact that the public is deceived or misled by the representations.

Volume of Worthless Securities

No one knows the amount of securities marketed in this country which could be classified as having been fraudulent or worthless at the time of issue. Various estimates have been made from time to time by presumably well-informed persons For instance, Dr. Leon Harp, Securities Commissioner of Texas and President of the National Association of Securities Commissioners in 1936, said in an address before the Investment Bankers Association of America in December of that year "The lowest estimate I have seen on the volume of securities frauds in this country is $1,000,000,000 per year." Mr. Houston Thompson, a former Federal Trade Commissioner, made the statement in a hearing before the House Committee of the Federal Congress that between $13,000,000,000 and $14,000,000,000 in "questionable securities" had been issued in New York State between 1928 and 1933. Still another estimate is that presented in a New York *Times* dispatch dated March 31, 1933, from Washington, D C., to the effect that, of $50,000,000,000

in securities floated in this country from 1920 to 1933, inclusive, half had proved to be either worthless or undesirable.

Methods of Protecting Investors against Frauds

There are now in the United States forty-seven state statutes dealing with security issues, a national postal fraud law, the Federal Securities Act of 1933, as amended, and the Federal Securities Exchange Act of 1934. All of these relate specifically to the prevention of fraud in the sale or distribution of corporate securities In addition, there are many state laws against fraud and deceit, obtaining money under false pretenses, and using schemes to defraud Assuredly, under this multiple legislation, fraudulent practices in the sale of securities can not be laid to the lack of legislation. All of these laws are implemented by an administrative organization constantly active to enforce the provisions of the laws.

For convenience in presenting the various protective measures, we shall divide them into (1) those provided by the federal government, and (2) state regulation.

Federal Protection: Federal Postal Regulations

The federal government is able to attack fraudulent stock-selling schemes, because in almost every instance where promotion is wrongfully pursued on a large scale, the mails are used by the promoters Criminal operations of this kind are covered by an Act of Congress, passed March 4, 1909, which is recited at length in Section 1907 of the Postal Laws and Regulations of the United States of America. This Act makes it a crime for one who has devised or intended to devise any scheme or artifice to defraud or for obtaining money or property by means of false or fraudulent pretenses, misrepresentations, or promises, to place, or cause to be placed, for the purpose of executing such scheme or artifice, any letter or other kind of mail matter in any post-office of the United States. The punishment therefore is a fine of not more than $1,000 or imprisonment for not more than five years, or both.

Efficient machinery is provided for the enforcement of the law above mentioned A corps of officials, known as the United States Postal Inspectors, is charged with the duty of investigating and assisting in the prosecution of infractions of the postal laws. The country is sub-

divided into nine districts for purposes of enforcing the law, each district in charge of a Deputy Chief Inspector, and each Deputy has a force of inspectors directly under him Each inspector must report daily to the Deputy Chief Inspector who is his immediate superior, and in this way the Department is kept in touch with the work of its subordinates. When a complaint comes to the Postal Department that an investor has been defrauded, the investor is asked to furnish evidence of the fraud. If he satisfies the Deputy Inspector that he has grounds for his complaint, one or more inspectors are appointed to investigate the matter, and at the same time the Chief Inspector at Washington is notified that a new complaint is pending If, after careful investigation, the Department believes that the complaint is well founded, that the mails have been misused, and that a crime has been committed, the evidence collected by the Department is submitted to the United States District Attorney, and at the same time evidence is forwarded to Washington with a request that a "fraud order" be issued against the accused promoter. Until it is rescinded, it prevents the accused from receiving mail of any kind, and thus protects the public. In justice to the Post Office Department, there have been few cases in the history of the Department where accusations of this kind, when seriously made, have not been sustained by the action of the courts. The principal objection to this method of prevention is that it goes into operation only after the securities have been sold, since it is only at that point that the victim becomes alarmed to the point of complaint This type of regulation might be classed as curative medicine. The purpose of laws against horse-stealing, for example, is not so much to punish the horse-thief as to provide that horses will not be stolen.

Federal Securities Act of 1933 as Amended

Following the panic of 1929 and the unprecedented destruction in security values resulting from the following depression, public confidence was shaken to such an extent that pressure was brought upon the federal government to pass some form of legislation that would more fully protect the American public from fraudulent security issues. The public became conscious at this time that many issuers of securities had misrepresented the value of their enterprises, and had concealed vital facts when seeking capital. Those state laws in effect were incompetent to supply the protection needed, due to the fact that many security issues

were sold in interstate commerce, and individual state regulations could only apply within their specific borders It was felt that the multiplicity of state laws, few of which were uniform, and few of which were administered with equal diligence, offered the fraudulent promoter protection, as well as the opportunity to continue his operations without the proper restraint. In March of 1933, President Roosevelt, in presenting the aims of his administration with respect to this matter, suggested, among others, the following

> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public The proposal adds to the ancient rule of *caveat emptor* the further doctrine of "let the seller beware" It puts the burden of telling the whole truth on the seller It should give impetus to honest dealing in securities, and thereby bring back public confidence.

Speaking further with respect to legislative needs in this direction, he said

> It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt in on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations.

The Securities Act, as passed and signed by the President on May 27, 1933, had for its aims the following

1. Insistence upon full disclosure of every important fact with respect to the issue of a new security,

2. A requirement that the action taken by the federal government in this connection should in no way be construed as a federal approval or guarantee of a security issue

3 The requirement that all persons, whether corporate directors, experts or underwriters, who sponsor the marketing of corporate securities should be held to the high standard of trusteeship.

The important provisions of the Securities Act are as follows.

1. *Definitions* —This section defines explicitly the various terms used throughout the act The word "Security" is defined as any note, stock, treasury stock, bond, debenture, evidence of indebtedness, or any instrument commonly known as a security.

2 *Exempted securities:*—The act specifically exempts from its provisions a considerable number of securities as follows

a. Federal, state, or local government securities, or those issued by any corporation acting as a United States government instrumentality and securities of federal or state chartered banks.
b. Commercial paper having a maturity not exceeding nine months
c. Securities issued by non-profit corporations or persons.
d Securities issued by savings and loan associations
e. Railroad or other common-carrier securities whose issue is subject to the Interstate Commerce Commission
f. Receivers' certificate or trustees' certificates.
g. Insurance, endowment, or annuity contracts.
h. Exchange of securities where no commission is paid for soliciting the exchange.
i Exchange of securities approved by the court or a governmental authority.
j. Securities sold wholly within a state by a corporation chartered and doing business within that state.

3. The Act prohibits the use of the mails or any instrument of interstate commerce for selling or transporting securities not registered with the Securities and Exchange Commission.

4. *Registration.*—The Act requires that all securities not exempt must be registered with the Commission, fixes a registration fee of 1 per cent of the maximum aggregate offering price of the securities, and provides that the information so submitted shall be available to the public.

5. *Information required in the registration statement:*—This section of the Act is of great importance because it is in meeting this requirement that a corporation presents the facts and figures which give a true picture of the company and the security to be sold. There are thirty-three items of information required, including the following

a. The name, state of incorporation, principal office, names and addresses of directors and underwriters of the issuer, and character of the business of the issuer.

b. Names and addresses of persons owning more than 10 per cent of any class of stock of the issuer or of all the outstanding stock.

c The capitalization of the issuer, both bonds and stocks, the specific purposes for which the new capital is to be used, the estimated net proceeds of the new issue, the price at which the security will be offered to the public, the amount of all commissions or discounts to be paid to underwriters, and all other expenses incurred in connection with the issue.

d. The salaries paid to all directors, officers, and other employees of the company, with names of those receiving more than $25,000 per year.

e The amount of any promoters' fees paid within two years, the names and addresses of the sellers of any property who will be paid from the proceeds of the issue, the extent of the interest of any director, officer, or chief stockholder in any property acquired within two years

f Detailed balance sheet and profit and loss statement in form prescribed by the commission

g Copies of agreements with underwriters, opinion of counsel on legality of the issue, all material contracts in effect with the corporation, the charter of the issuer, and all underlying agreements affecting the security to be offered for sale

In addition the Securities and Exchange Commission may require such other information and documents as it deems necessary for the protection of investors.

6. Registration statements become effective so that the securities can be sold twenty days after filing. If incomplete or inaccurate, the commission may refuse to permit them to become effective and may suspend effectiveness at any later time for the same reasons.

7 No securities may be sold to the public except by means of a printed prospectus which must contain all of the information given in the registration statement except a few items held not to be necessary,

and any other information which the commission may hold to be necessary or appropriate.

8 *Civil liabilities*—The Act provides that, if a false registration has been submitted, any damaged party may sue every signer of the statement, director, or partner in the issuer, accountant, engineer, or other expert who certified to any part of statement, and every underwriter of the security Such suits may be brought to recover either the price paid for the security with interest, or damages, if the person suing no longer owns the security

(Damages are equal to the difference between the amount paid for the security and (1) the value thereof at the time suit was brought, or (2) the price at which the security was sold in the market before suit, or (3) the price obtained from a sale after suit but before judgment.)

9 The Commission has power to change the rules and regulations whenever necessary to carry out the provisions of the Act and to petition federal courts, when violation is likely, for injunctions or mandamuses to compel compliance with the law.

10. Finally, the Act provides a penalty for wilful violation of the Act, or of the rules and regulations of the commission, of a fine not to exceed $5,000 and/or imprisonment up to five years.

Subsequent to the passage of the original act, a number of amendments were made, particularly in 1934, which did not alter the basic purpose of the Act, but which qualified certain of its provisions and made for easier interpretation This Act may be described, in a phrase, as "the truth in securities act."

The Securities and Exchange Act

At the time the Federal Securities Act was passed, it was felt that such a statute would only go part way in meeting the serious situation that existed with respect to fraudulent securities When it is realized that the promoters of new corporate ventures, having sought and obtained capital from the public by the sale of securities, would hasten to have these securities listed for trading on one or more of the stock exchanges, and that their interest would be best served by an active public participation in trading in such securities, they would bend every effort to induce a rapid rise in quoted market prices and an aspect of great trading activity By these means, misinformed persons would be influenced to buy the newly listed shares of corporate enterprises which,

in turn, would facilitate rapid absorption by the public of large amounts of new securities In other words, the organized trading exchanges were utilized as an adjunct to high pressure marketing of unseasoned stocks for the most part.

The Securities and Exchange Act, approved June 6, 1934, undertook (1) to control the manner in which the stock-exchange machinery should be used, (2) to protect investors from corporate directors, officers, and principal stockholders through publicity, and (3) to control what are known as over-the-counter markets, wherein securities are bought and sold by various dealers with little or no publicity as to price or margin of dealers' profit The provisions of the Act dealing with these matters may be summarized as follows.

1. The Act specifically prohibits various forms of manipulation and trading practices and devices to artificially affect market quotations The Securities and Exchange Commission is given the power to set up rules and to require the exchanges themselves to set up rules which will minimize unfair trading practices. For example, the Act holds it to be unlawful for any person to

- *a.* engage in any transactions devised to peg, fix or stabilize prices,
- *b* execute any short sales in registered securities,
- *c.* use stop-loss orders, or
- *d.* use other manipulative devices,

unless made in accordance with the rules set up by the Commission. In order to make sure that the machinery of the stock exchanges is being properly used, the Commission requires the submission of periodic and special reports For violation of these provisions, the exchange may be fined or its registration withdrawn, and members of the exchange may be suspended or expelled from the exchange. Furthermore, members of exchanges, as well as non-members, are subject to a fine and/or imprisonment upon conviction for violation in a federal court The powers of the Commission are very broad with respect to imposing rules and regulations for any exchanges which are believed to have been negligent in the regulation of their own activities.

2. The Act attempts to protect security investors from what have been termed corporate "insiders," chiefly through publicity. The law undertakes to procure for the small stockholder the same essential infor-

mation that large stockholders have always had access to, and to prevent the management from presenting the condition of their corporation in any other than its true light. Every security to be traded in on a national exchange must be registered with the Securities and Exchange Commission and, having registered with the Commission, the corporation is required to furnish to the Commission detailed information from time to time with respect to the corporate financial condition

This section of the act likewise regulates the solicitation of proxies from stockholders by officers or directors of the corporation. Any person who owns 10 per cent or more of the stock of a registered corporation, and every director and officer of the corporation, is required to file with the Stock Exchange and with the Commission at the end of each month the amount of his ownership in the stock of that company The Act also denies any such person the right to retain any profit made through the purchase and sale, or vice versa in the stock of his corporation within a period of six months Such profits go to the corporation Any short sales by any of the above-mentioned groups in the stock of their company are prohibited.

3 Another important phase of activity covered by the Securities and Exchange Act deals with over-the-counter markets It was felt that if the organized exchanges should be extensively regulated, many corporations or individuals interested in such corporations still desiring secrecy with respect to their acts would remove their securities from exchange listing and make use of the over-the-counter market If this were permitted it would tend to defeat one of the major purposes of the act which was "open prices openly arrived at" To accomplish this end the Act provides that all over-the-counter markets involving the use of the mails or any other instrumentality of interstate commerce, shall be regulated by the Commission in such fashion as it considers essential to protect the investor. Such regulation can control all transactions of this type, as well as requiring dealers and brokers who maintain over-the-counter markets to register with the Commission It was not the intention of the act to actively regulate these markets where they are satisfactorily providing a place for the sale of inactive stocks. It merely intended to control such markets, should an attempt be made to use them as a blind for dealing in securities now traded on the organized exchanges. Up to the date of this writing, the Commission has not yet found it necessary to establish rules for the regulation of this business.

The Securities Act and the Securities and Exchange Act are like preventive medicine. The requirement for registration of all securities other than those specifically exempt from the provisions of the Securities Act, the insistence upon complete, truthful statements of fact with respect to the financial condition of the corporation seeking to market securities and the purposes for which the funds are to be used, federal control of organized trading exchanges, as well as unorganized markets, all of these are intended to eliminate, if possible, many of the gross abuses which have developed in the marketing of corporate security issues and are often held to be fraudulent

State Regulation

State regulation of security issues began in Kansas in 1911 with the passage by that state of the first of the "blue-sky laws" The name "blue-sky law" was coined to describe legislation devised to restrict the reputed habit of the speculative promoter in capitalizing the blue sky above him. Since 1911, all but one of our forty-eight states have passed blue-sky laws of one type or another, Nevada being the one state with no statute of this nature. The blue-sky laws of the various states all fall into either one of two classes (1) those which may be designated as regulatory laws, and (2) those classed as fraud acts.

Regulatory Laws

Forty-three of our states and, in addition, the District of Columbia, have passed regulatory laws which attempt to regulate the marketing of corporate securities within their borders by forbidding their sale until application has been made to some state authority and permission has been received from that authority to proceed with the issue. As is evident from the brief description so far given, this type of blue-sky law is intended to be preventive in nature. There is a pronounced lack of uniformity among the forty-three states with respect to the provisions of their laws but, for the purpose of ready classification, they all fall into either one of two classes.

1. Licensing laws which provide for the licensing of dealers in securities, and which undertake to control security issues through the dealers by requiring that all dealers and in many states their salesmen be licensed by the state. Through licensing, the dealers are held responsible for fraud or gross negligence in their transactions, and the attempt

is made to restrict the privilege of selling securities to those firms or persons who can show clean bills of moral health.

2 Laws requiring permits for specific corporate issues. These state laws prohibit the sale within state borders of any corporate security unless a permit has been granted by the proper authority for the sale of each specific issue The issuer company must file with the regulative body certain information concerning the new issue. If the information is complete and satisfactory, a permit will be granted to the applicant authorizing the sale of those securities. The laws requiring permits for specific issues may be likewise subdivided into two classes

a Those which undertake to classify all securities as either speculative or non-speculative and apply the restrictions above mentioned only to those securities classed as speculative.

b. Those laws which divide all securities into a number of groups to provide for the exemption of certain groups which are considered to be sound For example, a number of states exempt from the provisions of their blue-sky laws any securities which are listed in certain standard manuals of financial information, such as Poor's, Moody's, or Standard Statistics In some instances this exemption is qualified by the statement that the information given in the manuals must be an adequate substitute for their own registration statement, while in other instances the exemption only applies if the manual rating indicates a designated minimum quality or par. Many states likewise exempt from registration securities which have been listed upon certain organized trading exchanges. For example, the listings on the New York Stock Exchange are exempt from registration in thirty-three states, with qualifications upon the exemption in a number of instances All securities authorized for issue by such regulative bodies as state utility commissions and the Interstate Commerce Commission are likewise exempt, as well as all issues of the federal, state, and local governments.

State Fraud Laws

Four states—Delaware, Maryland, New Jersey, and New York—have fraud prevention laws The fraud act may be designated as a curative law, in that it undertakes to apprehend and punish those persons found to be guilty of the perpetration of fraud in the issuance or marketing of securities. Here it is necessary, of course, that the act undertake to define fraud and fraudulent practices with respect to the marketing of securities. Or, if the act itself does not define fraud, the act will be interpreted and its provisions will be applied in the light of fraud as defined by the courts or some legal authority For example, the words "fraud" and "fraudulent practice" under the Martin Act of New York State were interpreted by the court [1] "to include all acts, although not originating in any actual evil design to perpetrate fraud or injury upon others, but which, due to their tendency to deceive and mislead the purchasing public, come within the purpose of the law 'Fraudulent practice' as used in this act, includes the employment of any device, scheme or artifice to defraud or for obtaining money or property by means of any false pretense, representation or promise, or the making of or attempt to make in the state fictitious or pretended purchases or sales of securities or commodities, or the engaging in any practice or transaction or course of business relating to the purchase or sale of securities or commodities which is fraudulent, or any violation of law and which has operated or which would operate as a fraud upon the purchaser."

The purpose of the Martin Fraud Act of New York, passed in 1921, is to prevent all kinds of fraud in connection with the sale of securities and commodities and to defeat all unsubstantial and visionary schemes in relation thereto, whereby the public is fraudulently exploited [2] The Martin Act provides for close cooperation between the State Attorney General and the State Supreme Court, as well as other courts. The Attorney General may examine witnesses called and books produced before a court He may petition any justice of the Supreme Court to order witnesses to appear for examination. The court may, at any stage of the proceedings under the Martin Act, appoint a receiver to take over the business or the assets of the party proceeded against, if

[1] People v Federated Radio Corporation, 244 N Y, 33
[2] *Ibid*

this is held to be in the public interest. The Act further contains extensive provisions for injunctions to be instituted by the Attorney General in the enforcement of the law The general provisions of the Civil Practice Act requiring notice to be given before an injunction will be granted, do not apply to injunction applications in proceedings under this act. Finally, on conviction of fraud, the Martin Act provides imprisonment for a term not to exceed seven years, or by a fine not to exceed $3,000, or both.

The Delaware blue-sky law, also of the fraud type, is the shortest, most simple law of this type to be found It does not regulate the issue or sale of securities, but is intended solely to prevent the fraudulent sale or exchange or proposed fraudulent sale or exchange within the state of Delaware, of stocks, bonds, notes, or other securities This act is also enforced by the Attorney General, who files a petition in the Court of Chancery asking for an injunction to restrain the sale or exchange of securities pending a hearing before the court with respect to the facts The act provides no specific penalties, but the Chancellor may not only grant permanent injunctions, but may also make such further orders as may be appropriate or necessary to carry out the intent and purpose of the act

The New Jersey securities law is drafted upon lines similar to the Martin Act of New York The Maryland blue-sky law is similar in nature to those here described, but in addition requires that dealers in securities register with the Attorney General of the state.

A serious weakness of state regulation of security issues is the lack of uniformity of the various state laws This condition produces confusion since a security admitted to sale in one state or not even required to be registered in order to be sold in another state might easily be refused registration in a third state It further adds to the expense of marketing securities, since the particular requirements of each state in which sale is to be undertaken must be canvassed and complied with before issue A uniform state law has long been advocated. Such a law was finally approved in 1931 by the National Conference of Commissioners on Uniform State Laws and by the American Bar Association The law, known as the Uniform Sale of Securities Act has been adopted by only two of the states, Florida and Oklahoma. It is a regulatory law providing for a securities commission, registration of securities as well as dealers and salesmen, exemption from registration where considered

desirable, revocation of registration of securities and dealers' and salesmen's licenses for specifically defined causes and penalty of fine and/or imprisonment for violations of the act. The general adoption of this or some other law which would give uniformity of state regulation is much to be desired

CHAPTER 21

THE MARKETING OF SECURITIES

The funds necessary for the development of a corporate enterprise to be owned and financed by the public are advanced by the promoters and proprietors of "venture capital" with or without the aid of bankers They receive, in exchange for their contributions, the securities of the corporation. These advances of funds are intended to be temporary Unless they expect to be permanently interested in the company, the original interests desire the release of the funds so that they may become available for the development of other undertakings. The financial institutions from which they may have borrowed expect their loans to be repaid The period required for the development of the opportunity may extend over a term of years Unforeseen difficulties may be encountered The time required for the company to make a satisfactory showing of earnings may be longer than anticipated However, the promoters wish to make this period as brief as possible. As soon as the company has reached a position so that its stocks or bonds are backed by a record of earnings, they are offered for sale to the public. The selling of the securities accomplishes the permanent financing of the corporation. It must be carried on in conformity with the provisions of federal and state laws previously mentioned which govern their distribution

There are available two methods of selling the securities, either to the public direct, or to investment bankers

Direct Method of Selling

If the promoting group does not include one or more persons engaged in or allied with an investment banking business, the association probably lacks the equipment essential in the selling of securities. The sale of the stock or bonds to the public requires the construction of a selling organization for that specific purpose, and since it would not be economical to keep such an organization together after the necessity out of which it originated had passed, its cost will be excessive. The company may rely on newspaper advertising to discover its customers, and

newspaper advertising is an expensive method of selling securities. Another method is to engage the services of an advertising agency or stock-selling firm to undertake, without any guarantee as to results, to sell the securities on the basis of a certain percentage of the proceeds. In some cases, this would run as high as 40 per cent, and the selling campaign might have to be abandoned before many of the securities were disposed of From every standpoint, the direct attempt to market the securities will be likely to prove unsatisfactory. The cost of distribution will be excessive, the results uncertain, and the risks great. These disadvantages of direct selling may be overcome to a certain extent, provided the securities can qualify for listing on one or more of the stock exchanges. The listing of a security brings it to the attention of those persons who are actively engaged in the buying and selling of stocks and bonds of corporations and who keep themselves advised with respect to changes in security values by consulting the record of transactions which are published daily in the leading newspapers As a consequence, the market for a listed security is generally broader than that of securities which are bought and sold "over-the-counter" Furthermore, if the purchaser of a listed security of a comparatively young corporation becomes dissatisfied, he can sell it in the public market provided by the stock exchange.

Indirect Methods of Selling

The indirect method of marketing corporate securities is to sell them to investment bankers. If the promoting group includes one or more investment bankers, which is frequently the case, particularly where the new corporation is a consolidation of a number of companies, they will sell the securities to an underwriting syndicate, a method which will be explained in the next chapter. If the promoting group does not include any bankers, the sale of the securities will be negotiated with some banking house outside of the group. Investment bankers stand ready to purchase the securities of corporations for cash. The prices which they offer are below those which they expect to receive. The margin of profit depends on the salability of the security, and the salability on the investment quality.

There are many advantages obtained from placing the securities of corporations with investment bankers The cost of effecting sale is determined in the banker's contract. The exact amount which will

be received for them is known. The price, moreover, will be paid at a definite date The cost of selling securities to bankers is also less than if sales are made direct to the public, and the certainty of return is greater The banker has a permanent organization and an established clientele of customers This organization is constantly employed in marketing securities Established banking houses of good reputation have a large number of customers who will buy from no one else. They can count on a certain amount of funds from these customers, at more or less regular intervals, which will be used to purchase securities which they have to offer. They can also make a market for new securities, for which the demand may be weak at first, by exchanging these new securities on a favorable basis for seasoned stocks and bonds of long standing, previously sold to their customers, and for which a ready market exists. Customers may not have the funds with which to buy the new issue, but they have good securities which are salable, and if satisfactory terms are offered, they will be influenced to exchange these old securities for those of a new issue. The banker then quickly disposes of the seasoned securities. In a rising security market a very large amount of the "sale" of new issues represents their substitution for old issues By exchanging the newly issued securities for those well established, and then disposing of the latter, the banker can draw freely upon a large fund of purchasing power in the hands of the holders of the old issues. It is customary in such cases to allow the purchaser a slightly lower price than the market for the new issue, to encourage the making of a large exchange of old securities for new. This shading of the market price for purposes of exchange is not countenanced by many investment bankers, but is nevertheless quite common. Bankers, moreover, are not obliged to force a market for the securities which they purchase. They borrow from banks to carry stocks and bonds until a favorable time arrives for selling them.

The Organization of the Security Business

The security business is organized along lines similar to the business of producing and selling commodities. The corporation corresponds to the manufacturer, the investor to the consumer. Between the manufacturer and the consumer stands the distributor. The wholesaler in the field of commodities, and the banker in the field of securities, occupy similar positions. Investment banking firms are divided into houses of

issue, or originating houses as they are sometimes called, wholesale distributors of securities, like Morgan Stanley Company, Speyer Company, and Kuhn, Loeb and Company, who deal with established corporations direct, or with the promoters of new enterprises, and retail firms who distribute these securities to investors and financial institutions The line of division between houses of issue and houses of distribution can not be clearly drawn, since both at times invade the field of the other. Issue houses sell direct to large institutional buyers, and retailers often join in issue syndicates. Some houses of issue may organize their own machinery for retail distribution, offering the issues which they sponsored to the investors.

The marketing of securities, as a branch of merchandising, is not a function of the commercial bank. For a number of years, certain large securities companies, such as the National City Company, the Chase Securities Company, and the First National Company, which were owned by stockholders of commercial banks with the same surnames, operated in close affiliation with these banks. The certificate of stock of the securities company was incorporated in the bank stock certificates, so that the mutual interest was permanent. Through these affiliated companies, for all practical purposes, the commercial banks engaged in the business of investment banking This condition of affairs was brought to an end by certain provisions included in the Banking Act of 1933, approved June 16, 1933. This act states, among other things, that national banks are not to do an investment banking business, although they may buy and sell securities (not including stocks) upon the order of customers and may purchase for their own account, under such restrictions as the Comptroller of the Currency may prescribe, that "after one year from the date of the enactment of this act, no member bank shall be affiliated in any manner with any corporation, association, or similar organization, engaged principally in the issue, flotation, or public distribution of stocks, bonds, or other securities," and that, "after one year from the date of the enactment of this Act, no person, firm, corporation or similar organization, engaged in investment banking, shall engage at the same time in the business of receiving deposits" These provisions have been responsible for bringing about the divorcement of the commercial and investment banking businesses from each other.

The investment banking house may carry on certain departments of

the business of the commercial bank. In addition to offering securities, the investment banker furnishes to investors, free of charge, accurate information on securities, collects and remits dividends and interest, negotiates or makes collateral loans for various classes of borrowers, executes orders for the purchase, sale, or exchange of securities on the stock exchanges, and in some cases carries on the business of foreign exchange The distribution of securities is, however, the primary function of the private banker. To this, all his other activities are subordinated

The retail investment house organizes its business along the lines of a commercial jobbing house. It has a large number of present or prospective customers on its list, sometimes running into the thousands It circularizes these customers with letters and pamphlets, follows up inquiries with prospectuses, and also brings the merit of its wares to the attention of the security buyer by public advertisements. The investment banking house enjoys special advantages for the financing of its business. So far as possible, it makes its sales and purchases coincide. In an active securities market, it is not unusual that a large issue should be sold before the firm is obliged to make its final payment. When an issue of securities can not be readily sold and has to be "carried," the investment banker employs his lines of credit with banks and trust companies, pledging the undistributable securities as collateral for loans. By this employment of its credit, it is able to transact a large volume of business with a comparatively small capital investment An investment banking concern with a capital of $1,000,000 is a substantial institution in its field, and can not only participate in important undertakings originated by other firms, but act as an origination house.

In a previous chapter, under the discussion of capitalization, a classification of new enterprises has been made. These are new enterprises in the broadest sense of the term; the exploitation of a patent, a new method of selling, for example, the Piggly-Wiggly Stores or the Giant Markets, or by the Vending Machine Companies, or a new form of financial institution, illustrated by the investment trust. To these there is added the large class of mineral enterprises, gold-mining and oil being the most conspicuous illustrations, where the amount, value, and cost of working the deposit is uncertain

These industries are essentially speculative. There is no satisfactory

record of production, sales, or earnings, upon which a forecast of their profits can be based. Their situations involve a large number of unknown factors The money which is put into their development was recently described by Mr Lamot du Pont as "venture capital."

With such companies the investment banker, as such, will have nothing to do. He may, as a private individual, take an interest in a promotion syndicate or even buy the securities of a new corporation outright The inventories of estates of wealthy men usually contain securities of this character. Occasionally, as with the late Senator George Hearst's adventures into the Homestake Mine, the speculation is enormously profitable, but the percentage of losses to gains is high. These enterprises are operating in the twilight. They can not see clearly the path before their feet.

There are two other classes of new companies which, while ranked as new, still have some foundation of experience to go upon. The first is the consolidation of existing enterprises, the parts of which have been in successful operation for many years. Standard Brands and General Foods are recent illustrations of such consolidations. Here the investment banker will handle the securities because there is a record of earnings upon which he can rely as the investment basis of the proposition, while the so-called economies of consolidation are relied upon to produce a speculative profit. Here is a combination of speculation and investment from which the investment banker, in normal times, does not shrink.

There is also the class of undertakings for which the methods of production and volume of sales, under known conditions, can be forecast with a fair degree of accuracy; for example, the establishment of a water company or an electric light and power company in a new territory where the population has grown to a point to be able to sustain a utility of this character, where, while the enterprise is new, yet it is operating under known conditions and its success can be predicted with a fair amount of certainty.[1]

Beyond these three classes of undertakings, first, those with a known record of earnings in their existing form, second, the consolidation of established enterprises; and third, the development of established industries in new locations, the investment banker will not often go. He

[1] See Chapter 16, *supra.*

will not buy the securities of an oil company which holds leases in oil-producing territory He will not buy the securities of a gold-mining company. He may buy, under given marketing conditions, the securities of a lead, copper, or zinc mining company where the amount of the deposit can be definitely ascertained, and where the market for these products is active and growing. In general, the distinction between those companies which the investment banker will finance and those which he will reject is the distinction between the known and the unknown, between the realized and the problematic There are many exceptions to this rule, but in general the distinction holds.

Responsibility of the Investment Banker

When the investment banker is approached by the promoters of a new enterprise and asked to assist in the flotation, he examines carefully the character of the project He first demands of the securities which are offered to him that they be salable. Unless he can sell them at a profit, he is not interested. Assuming that the securities are salable, the next question is, can he recommend them to his customers? The banker is a seller of securities. By an extensive organization, covering sometimes many states, he keeps in touch with funds offered for investment. He has classified in his files, the names of thousands of people who buy securities, he knows how much money they have to invest and when this money will be available He has an organization of salesmen who make regular visits to his customers, and he carries on an extensive correspondence with prospects and old customers, to influence their purchases. This business the investment banker expects to be permanent If he sells a bond, maturing in ten years, he has a record of that sale, and when the bond is paid, he expects to be on hand with a new bond to take the place of the old one. He aims to cultivate, by every means in his power, the good-will of his customers The basis of that good-will, the foundation upon which his business must rest, is the investment quality of the securities which he offers. In his literature and through his salesmen, the banker lays primary emphasis upon safety. To his customers he recommends securities which he has bought himself before he offers them for sale. His endeavor is to protect his customers against loss He will carry these efforts, in some cases, so far as to repurchase bonds concerning whose security there may be a doubt, or to undertake, at considerable expense and trouble, the work of reorganizing bankrupt

companies whose bonds he has sold, so that they may again be put upon a solvent basis [2]

The banker can not recommend speculative bonds or stocks to his clients. He might indeed sell a large amount of doubtful securities, during a period of abnormally large earnings, which would be bought from him by his clients because of their confidence in him, but when depression overtook these shaky enterprises, they would go down, and with them would go the good-will of the banker's business A long record of successful flotations is not sufficient to protect a banking house against the discredit of offering and recommending securities which are not good, and whose quality could have been revealed by an investigation.

An illustration of the caution displayed by reputable financial institutions in standing sponsor for new and untried companies, is the following letter in answer to an inquiry concerning the merits of a Mexican mining proposition which had announced that subscriptions to its bonds would be received at a prominent trust company, large use being made of the trust company's name in the advertisements The inquiry addressed to the trust company was as follows

DEAR SIR

I have received certain information on the proposition offered by the ———— ———— These reports are extremely interesting, and I have given them careful attention I should like, however, to have your own opinion of the merits of the debenture bonds as a safe investment

The Corporation ————, by its Vice-President, Mr ————, has heartily recommended them, and I presume you will have no hesitancy in confirming his statement that he believes them to be a safe and profitable investment.

[2] Hayden and Stone, as an example, once sold an issue of bonds of the Shipman Coal Company Owing to misrepresentation by officials of the company, as to the amount of coal reserve, the bonds turned "sour" and a receiver was appointed The bankers issued a circular to the bondholders, stating that officials of the company were liable to bondholders for the loss sustained, and that if the bondholders would assign to the bankers their several interests in any recoveries from these officials, proceedings against whom would be undertaken at the bankers' expense, they would reimburse these bondholders in full when the cases were finally decided The amount involved was $800,000 This offer by bankers, because of its size, was looked upon as unusual In another case, however, a banking firm brought out an issue of silk bonds. Because of misrepresentation to the experts employed by the bankers as to the amount of current assets, the amount of bonds sold was too

The reply of the trust company is as follows

DEAR SIR

We have your favor of the 18th inst In reply thereto would say that following our invariable policy, we regret our inability to advise you in the matter of the investment referred to Our duty is merely to receive such subscriptions as may be tendered on behalf of the ——————— ———————, and we have been selected to countersign the bonds The parties interested in the matter have come to us properly recommended

The statements contained in the advertisement and circulars are the statements of the ——————— and not of this company

Yours very truly,
(Signed) ———————
SECOND VICE-PRESIDENT

If the securities of the new company are speculative, the banker can not purchase them and offer them as his own property to his customers. He can, however, insure or guarantee their sale. The trust company just mentioned could have been interested in these bonds at its own risk, or by lending to officers and directors on the security of the bonds, without openly indorsing them, unless the use of its name as the depositary of the mining company may be regarded as an indorsement

Banker Management

During the decade following the first World War, some investment bankers went so far as to identify themselves with the management of the concerns which they financed, and even to assume responsibility for the management by means of voting trusts or special issues of stock carrying the right to elect a majority of the directors Dillon, Read and Company were prominently identified with this new development Investment bankers have always kept in close touch with the companies for which they act as fiscal agents Many railroads, for example, are known as Morgan roads or Kuhn, Loeb roads These banking houses, until the Clayton Act forbade the practice, were represented by partners or associates on the boards of directors of corporations whose securities they sold.

The 1926 report of the Industrial Securities Committee of the Investment Bankers' Association had this to say concerning banker manage-

great for the company's earnings, and default resulted While the bankers assisted in the reorganization, they did not, so far as known, reimburse any bondholders

ment of enterprises through the holding of management stock (or by voting trusts)

First of all, domination of a corporate voting stock carries with it responsibilities of the most serious nature Whenever a house of issue elects to retain the domination of a company's affairs, it must be prepared to accept fully the responsibility that goes with it, and to act with the impartial purpose of doing only what may be best for the company and for the public All this probably means the expansion of its activities along business lines for which as an organization it may have no special aptitude nor means of securing satisfactory personnel.

Second, it is by no means certain that the courts will exercise the same measure of control in the case of a majority action of stockholders where all common stock is entitled to vote, as in the case of a majority action of stockholders where only a part of the common stock is entitled to vote. Claims of mismanagement and negligence on the part of controlling directors and officers, and perhaps the controlling stockholders, might be listened to by the courts with a more attentive ear in the latter case than in the former. New laws, statutes, common law and equity are made to fit new cases so that the legal rights of voting common stocks where non-voting common stocks exist may carry with them obligations, the exact nature of which cannot at the time of issue be determined, and which, if it could be known, it would not be good judgment to assume

The Interstate Commerce Commission, in several rulings, has considered the relationship between bankers and railroads, and in certain equipment trust issues has ordered the bonds opened to public bidding, believing that for securities of this character better prices could be obtained by public offering than by selling to one banking house. This method is general in the case of municipal bonds. As yet, however, the sale of securities through fiscal agents, investment banking houses, is the prevailing method. A recent development, which investment bankers deplore, has been the direct sale of bonds to institutions, by-passing the banker and his commission. These sales have been very large. The issuing corporation receives a higher price, and the buyer pays a lower price Bankers claim that the borrowing companies, for the sake of a small saving, are sacrificing the advantage of the service which their bankers can give them in the management of their financial affairs and weakening the security which close relations with their bankers will provide against the time when securities are less easy to sell than they are at present.

CHAPTER 22

UNDERWRITING

Function of Underwriting

Public flotation of securities usually requires the aid of an underwriter. An underwriter, as his name implies, insures or guarantees the sale of securities within a certain time at a price sufficiently below the anticipated market price to insure a profit to the guarantor. It is a matter of indifference to the corporation whether its securities are sold outright or whether a responsible syndicate guarantees the sale In either case, the needed funds are provided at once by the bankers, who must look to the sale of the securities, which they have underwritten or purchased, for reimbursement.

In underwriting the securities of a new company, or in purchasing them outright, the banker who undertakes the responsibility of the transaction usually associates with himself a number of other individuals and banking houses in an organization known as an underwriting or subscription syndicate The difference between underwriting and subscription is that in underwriting, the banker, for a fee, agrees to take and pay for at a stipulated price all of the securities which are not sold to the public, while in subscription he buys the issue direct from the corporation at a price. In the latter arrangement, if the issue is large, the banker usually has other "houses" underwrite the ultimate sale of the issue Underwriting of the securities of newly formed corporations is seldom encountered Usually underwriting is employed where an established corporation is offering an issue of new securities to its existing security holders, as when it is undertaking new financing, or refunding, or some form of conversion. Here the corporation wishes to be assured that if its security holders will not purchase all of the new issue, some one will stand ready to buy at the same price. With most issues of new companies, the syndicate manager agrees to purchase the securities and markets them wherever he may find purchasers In either case, the association which is formed to assist him in carrying out his contract with

the corporation is substantially identical, and the two forms of syndicate underwriting and subscription may be considered together.

The Underwriting Syndicate

The underwriting or purchasing syndicate is a voluntary and temporary association of individuals or firms or corporations which is formed by a syndicate manager, usually a banking firm, to assist him in guaranteeing the sale of, or in purchasing an issue of stocks or bonds The steps in the organization of the syndicate are as follows

The original contract is made between the members of the syndicate and the issuing corporation, by which the syndicate agrees either to purchase certain securities at a price or to guarantee their sale within a certain time at a certain price Each syndicate member contracts for a stipulated portion of the issue

While the syndicate manager may be a strong banking firm—such as Morgan, Stanley and Co. or Kuhn, Loeb and Company—and may be able to guarantee the flotation of a very large issue of securities, it is usually advantageous to organize a syndicate. Most banking houses have a definite policy which regulates the amount of capital which they will allot to a particular venture The house, for example, with a capital of $10,000,000 may have a rule that it will not invest more than $1,000,000 in any one undertaking, so that any losses which it may sustain by unsuccessful ventures may be offset by the profits of those which have been profitable.

The Underwriter's Associates

By admitting other bankers with wide connections and large numbers of clients to share in the profits of its subscription, a banking house obtains a broad market for the securities which it has for sale, and by adopting this policy in all its undertakings, it makes sure of quicker returns A bond issue of the American Telephone and Telegraph Company, for example, was taken by J P. Morgan and Company, Kuhn, Loeb and Company, Kidder, Peabody and Company of New York, and Baring Brothers of London. Ordinarily, the subscription would have been offered to a New England banking house, but the New England market was unable to absorb more telephone securities and a broader market was required, to obtain which the cooperation of New York and

London houses was enlisted. An eastern house, undertaking the underwriting or purchase of bonds of a western enterprise, associates with itself, if possible, western bankers whose clients are likely to be familiar with the enterprise.

Organization of the Underwriting Syndicate

The syndicate is organized as follows The company arranges with a banking house to organize a syndicate to buy an issue of bonds. The head of the banking house communicates with a number of firms and individuals with whom they have cooperated in the past They will recite the facts in their communications to those whom they wish to join in the syndicate, and they will ask each one to indicate by return mail or telegraph, the amount of participation in the syndicate, which he desires. One house will ask for $1,000,000, another for $5,000,000, the third house for $500,000 and so on Very few will decline. To refuse to participate in a syndicate when requested by a house of standing *may* result in excluding that banker from participation in desirable future business which the syndicate head may reserve for his always dependable allies After the replies have been received, one of two results may be shown The applications for participation in the syndicate may exceed the amount of securities which have been underwritten or purchased, or they may be below the required amount In the second case, unless the deficiency is large, the plans of the syndicate manager are not disarranged, since he expected to take a certain amount of participation in the syndicate himself, and forthwith sets aside for his own firm the amount of the deficiency in subscription It may, however be necessary, in case his request for applications does not meet with a cordial response, for him to assume a much larger part of the responsibility than he originally intended. This contingency is avoided by offering participations in the syndicate to such a large number of important houses and financiers as to make it reasonably certain that the combined requests for participation will exceed the amount which the syndicate manager considers necessary. In most cases the amount will be largely oversubscribed He may require only $20,000,000, and the sum of his applications to participate in the syndicate may be $30,000,000

It is now necessary for the syndicate manager to allot these subscriptions. Since this is an association resembling the corporation, in which

the liability of the participants is limited to the amounts of their subscriptions, it might be supposed that every one would stand on the same footing, i.e., when allotments to the stock of a corporation are made, if the requests are twice the amount necessary, each subscriber will receive half of the amount asked for.

Operation of the Underwriting Syndicate

With the underwriting syndicate, however, the procedure is different. This voluntary association—a kind of temporary corporation—is for the individual benefit of the syndicate manager. It is a business enterprise which he is promoting.

While the manager requires the members of his syndicate to indicate how much participation they desire, he does not guarantee to give them all they ask for. He makes his allotment according to his own advantage and he considers nothing but his own interest and the interest of the corporation for whose financial affairs he is temporarily responsible He may assign one applicant 100 per cent of his application, another 50 per cent, another 10 per cent, and another 5 per cent. No member of the syndicate is likely to be informed by the syndicate manager, although he may easily learn from members directly, how much of his request another member has been allotted

The principles which govern this allotment, looking at it from the viewpoint of the syndicate manager, are as follows·

In the first place, he wishes the flotation to be a success, and he makes his allotment with this object in view. A particular kind of security—for example, bonds with leasehold instead of real property security—will in his judgment, find a ready market in Cleveland. He will allot the full amount of their applications to Cleveland bankers. If a flotation of a similar character has failed in Baltimore, Baltimore bankers will have to be content with a small share of their applications.

On the other hand, individual financiers who are not able to assist in marketing the bonds, or applicants for small amounts, may receive only small percentages of allotment. The syndicate manager expects to be in business for many years, he wishes to participate in underwriting syndicates managed by other bankers. When he receives an application from a banker who is himself a manager of syndicates, he will give that banker what he asks for, since otherwise he might himself be cut off from some profitable participation in the future. Participations in syndicates,

in other words, are sometimes allotted for the sake of securing participations in other syndicates. A banker makes his allotments to cultivate business good-will and to strengthen his position and influence by the disposition of the allotments which are entirely in his hands.

The position of the banking houses who are invited into the syndicate is similar to that of the organizers of the syndicate. The issue houses need the retail houses as distributors. The retail houses can not prosper without the support of the issue houses. This second consideration explains why many issues of inferior quality are so quickly sold. Retail houses take these because they wish their share of the high-grade bonds, whose disposition, because of the system of fiscal agencies previously described, the issue houses control. The retail house, in order to get bonds which his customers demand, must also take bonds which may be difficult to sell

The Underwriting Agreement

After the syndicate manager has decided upon the allotments, he sends to each subscriber a copy of the syndicate agreement, which the subscriber signs, and opposite to his name places the amount of his allotment. The subscriber is then bound by the conditions of the agreement, up to, but no further than the amount for which he has subscribed Provisions found in underwriting agreements are as follows

1 The subscriber agrees to take and pay for the amount of securities for which he has subscribed when called upon by the syndicate manager, and this agreement may be enforced against him in the usual manner by a suit at law.

2 He agrees that the syndicate manager shall have entire charge of the marketing of the bonds or stock, that he may make any and all contracts and incur any expenses necessary to secure their sale, and that all these charges and expenses shall be a first claim upon the profits of the syndicate

3. It is usually, although not invariably, agreed that the syndicate manager shall assign to the members of the syndicate a certain percentage of the profits on the transaction The remainder, sometimes one-fifth, sometimes a smaller amount, is reserved as his own profit.

4 The syndicate manager also reserves the right to participate, up

to the amount of his reservation for himself, as a regular member of the syndicate.

5 Any member of the syndicate may, at any time during its life, withdraw any of the securities at the price named in his subscription, although he must not resell these withdrawn bonds until the syndicate is closed.

6 It may be provided that he may assign a portion or all of his responsibility to the syndicate manager or others, and that, with the consent of the syndicate manager, he may, in this manner, be relieved of his responsibility.

7. It may be provided that the members of the syndicate are to cooperate with the syndicate manager in borrowing a portion of the price of the securities underwritten or subscribed for, from banks, in which case their participation may be put in the form of an assignable instrument so that the syndicate manager can assign it as additional security

8 The syndicate manager agrees to be responsible for good faith in the management of the syndicate, and in the distribution of profits, and for nothing else.

The terms of the underwriting agreement carry out the idea that this is the private enterprise of the syndicate manager, which the members enter on his terms, and which leave him in absolute control of the syndicate. His associates in the syndicate place the management in his hands He may make or modify contracts in the interest of the syndicate, he may incur such expenses as he deems necessary, and he is frequently authorized to pledge the subscriptions of the members to provide the funds necessary for his advances to the company.

Buying and Selling Groups

Underwriting a large security issue usually involves two stages (1) the buying syndicate, which deals through the syndicate manager, directly with the issuing company, and (2) the selling-group syndicate, which may include certain members of the buying group, but whose membership is much larger. The selling group buys the issue from the purchasing syndicate and distributes the securities to the investors The buying group may take two points' profit in the transaction, and the selling group an equal or greater amount. The organization of these

syndicates is similar, and the responsibility of the members is the same.

After the buying syndicate has been organized, the syndicate manager usually makes a call upon the members for a certain percentage, often 25 per cent of their subscriptions. This must be paid in cash With these subscriptions as a basis, he borrows the balance of the amount necessary from banks and trust companies. These loans he may make on his own security, with the pledge of the bonds or stocks which he has underwritten or purchased, or the certificates representing these securities, or he may, as above described, pledge in addition the responsibility of the members of his syndicate. In financing new projects, the fact that responsible underwriters have agreed to purchase the securities on which the syndicate manager proposes to raise money makes these securities much more desirable as the basis of a collateral loan The lending bank has an assured market, in which the entire issue of bonds can be promptly sold at a fixed price Formal pledging of the underwriting agreements is, of course, seldom necessary The lending banks know of the underwriting, and are glad to accommodate the syndicate manager without requiring the assignment of his agreements

Term of the Syndicate

An underwriting syndicate is organized for a certain term At the end of that term, if the securities are not sold, two alternatives are open either the syndicate can be extended, in which case the securities remain in the hands of the syndicate manager and the loans which he has made to supply the cash to the corporation, are renewed, or the syndicate is dissolved. The proceeds of the securities which have been sold are then applied to paying any loans which may have been incurred, and the unsold securities are distributed to the members of the syndicate, according to their several participations, payment being made in cash It is customary to make at least one extension of a syndicate which has not been successful during its original term, and in some cases the syndicates have been extended several times.

The syndicate manager may not have chosen to carry on the operation with the proceeds of loans, and may have called upon the members of the syndicate to pay up the full amount of their participations before the term of the syndicate has expired In this case, since they have all paid for the securities, the dissolution of the syndicate involves merely the distribution of the unsold securities among the members

In settling the affairs of an underwriting syndicate, the syndicate manager renders no accounting to the members, nor is any accounting asked for. The transaction is based upon good faith, and legal guarantees are not required There is no instance on record where a banking house of good reputation was sued for an accounting by members of a syndicate which it had organized. If crookedness or sharp dealing were attempted by a syndicate manager, even though he renders no accounting, the fact would soon become known and would make it impossible for him to secure participation in future syndicates. Thus the accounting is unnecessary in order to insure fair dealing If any member of a syndicate fails to pay for his bonds as requested, no proceedings are instituted against him by the syndicate manager He is dropped from the manager's list, and it may be difficult for him to obtain financial assistance or an opportunity to participate in profitable financial operations in the future Instances of such default are rare The consequences to a man's reputation are too serious Syndicate members will strain every resource and will dispose of their participations even at a heavy sacrifice in order to make good their word to the syndicate manager.

Risks of Participation in Underwriting and Subscription Syndicates

Participations in underwriting and subscription syndicates are sometimes very profitable. If market conditions are auspicious, it frequently happens that the entire issue of securities may be sold to the public before any calls are made upon the subscriber Usually, however, a portion of the subscription is called, but if the syndicate is successful, only one call is likely to be made. The syndicate which subscribed $200,000,000 to assist in the flotation of the United States Steel Corporation, paid in $25,000,000 and received back $65,000,000. On the other hand, the security markets may be unfavorable, owing to stringent money markets, or to distrust of some classes of investments, and syndicates may be left with large amounts on their hands which their members must carry, sometimes for years, before they can dispose of them at a profit

As an illustration of the risks assumed by underwriters, the experience of bankers with the Italian loan in 1926 is valuable. *The Wall Street Journal* of May 10, 1926, has the following

Fall of Italian Government 7% bonds Saturday to 88½ following dissolution of the syndicate, was not altogether surprising. Brought out last November to the amount of $100,000,000 and offered at 94½ to yield 7 48%

to maturity in 1951, the distribution of the issue was not entirely fortunate

> In the first flush of the large subscription, the bonds sold at 94⅞, but quickly settled back to the opening price.... Prominent members of the syndicate declared that prior to the clearing up of the syndicate books last week, it had twice been absolutely out of the bonds, only to have them pour back on its hands by the million a few days later.

The syndicate managers distributed the unsold bonds to its members, which, on November 8, 1927, had recovered to 97. The burden of this risk is not, usually, of permanent loss but of deferred profits.

The financial service of underwriting which is provided for corporations in effecting the distribution of their securities has been subjected to a certain amount of restraint since the passage of the Securities Act of 1933 as amended Section 2, paragraph 3 states, "The term 'sale,' 'sell,' 'offer to sell,' or 'offer for sale' shall include every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value, except that such terms shall not include preliminary negotiations or agreements between an issuer and any underwriter." The result of so defining these terms is that investment bankers may enter into underwriting agreement with corporations issuing securities before a registration statement is filed with the Securities and Exchange Commission. However, a selling group, a wholesale group, or a selling syndicate may not be organized, nor may any part of the issue be disposed of to dealers, nor may dealers make offers to purchase part of the issue, until the registration statement has become effective, which the law provides shall be the twentieth day after it has been filed.

Recent Growth in Private Offering of Security Issues

Since 1933, when the Federal Securities Act went into operation, there has been a pronounced increase in the volume of privately placed security issues The investment banker plays no part in these sales The corporation arranges with one or more institutional investors to take an entire issue of bonds. The chief purchasers have been the life insurance companies Out of a total of over $2,900,000,000 of private placements from 1934 to 1939 inclusive, the life insurance companies bought 83 per cent The following table [1] shows the extent of the shift away from the established marketing channel of investment banker and syndicate.

[1] From an unpublished study made in the Wharton School in 1940 by Walter S Hammond

EXTENT OF PRIVATE OFFERING OF CORPORATE SECURITIES
1934-39

Year	*Total Offerings*	*Private Offerings*	*Percentage of Private to Total Offerings*	*Number of Private Issues*
1934	$491,000,000	$100,939,000	19.4	21
1935	2,500,000,000	445,095,000	14	64
1936	4,200,000,000	507,292,000	10.4	73
1937	2,400,000,000	451,018,000	18.7	117
1938	2,000,000,000	680,512,000	31.8	127
1939	2,000,000,000	717,837,000	32.9	128
Totals	$13,591,000,000	$2,902,693,000	21.4	530

It is reasonable to assume that private offering benefits both the corporate issuer and the investor, the former in a higher price for its bonds, and the latter in a lower purchase price. The private sales are made by sound, established corporations whose bonds are sought as investments. The investment bankers are seriously concerned by the trend shown above, not only because they are losing a large volume of business, but because such issues are of high quality, sell quickly, relieve the banker of much selling effort, and do not have to be carried or supported for any length of time.

CHAPTER 23

BUSINESS PLANNING

No form of activity, social, economic, or military, can succeed without a plan Every business corporation, as we have seen, is organized according to a plan The business opportunity is investigated, the capital structure is set up, the administrative organization is established, according to plans which follow recognized rules After these preliminary plans are carried out and the corporation is organized for business, the next step is to plan for sale and production Subsidiary to these productions and sales plans, is the plan for current financing, by which the proceeds of sales are collected and disbursed.

We are here concerned with the planning for operation The first step is the preparation of a series of budgets A budget is defined by the National Industrial Conference Board as "a planned forecast of expected business operations for a definite period expressed in numerical terms in accordance with accounting forms employed to record the operations of the enterprise"

The Sales Budget

The first budget to be prepared by the administration of a new enterprise is the sales budget. Profit is the object of every business corporation Profits are the proceeds of sales less the costs of production and sale In the early days of American industry, production for stock was more common than it is to-day Inventory losses often resulted, with the important exception of agriculture, where production follows the routine of the seasons, relying upon long-established demand The modern method is to produce only on order. This exception of agriculture proves the rule that business, to be successful, must operate on an assured market. American agriculture has, for many years, been depressed because the farmers, each one operating for himself, have brought into the market supplies of corn, wheat, tobacco, and cotton which could not be sold at prices to yield profits. As a result, the American farmer, as a class, has earned less per capita than any other employed

element of the population. The government, beginning with the Hoover administration, has formulated many plans for the guidance of the farmer, and has spent a vast amount of the taxpayer's money in executing these plans On the other hand, the Departments of Agriculture, state and national, have shown the farmer how to increase his production, and then the federal government has paid him up to $900,000,000 a year to reduce his output to the demands of the market. Government is not always a successful planner

In the formulation of the sales budget, the business man starts from orders supported by contracts He will not start production, incurring expenses in the purchase of raw materials and employment of labor, until he has reasonable assurance of orders This rule, that production must not be undertaken until sufficient sales are made to cover operating expenses and overhead, is subject to numerous exceptions At times the demand for raw materials, and for some finished products, is so great as to make sales effort largely unnecessary If the goods can be produced according to the required specifications, they can be sold This was illustrated by the war demand for such articles as coal, copper, and steel During the "baby boom" of 1935, 1936, and 1937, serious shortages developed in certain raw materials, for example, copper, sulphite pulp, and pig-iron. Many plants which had been closed for years were refinanced and reopened to supply this demand. The scarcity in some lines was so great that there was no question of selling. In the real estate boom which started after the World War and culminated in 1926, the demand for houses was so great, due to the shortage of living space, that builders would erect hundreds of small houses at a time, and sell them as fast as they could be completed These situations are exceptional As a rule, in order to make sales, strenuous efforts and large outlays must be made. The sales department of any business, large or small, makes the most important contribution to success.

Classification of Sales Budgets

Sales may be divided into two general classes (1) sales for utilization in industry, or for re-sale in commerce, and (2) sales for individual consumption Industrial sales are usually protected by contracts with buyers

In the building industry, the production of houses is based upon written contracts from responsible persons to buy the houses. These

contracts are supported by written commitments by responsible finance companies to provide the buyer with most of the purchase price. The builder usually looks to the buyer for the "equity" money, over the amount secured by mortgage, and even this, if there is any doubt about the buyer's solvency, he may require him to deposit in advance. The same rule holds with consumer's capital goods The sale of automobiles, for example, is based on dealers' orders, and the dealers are responsible for their orders The dealer, in his turn, when he sells a car, is assured of his payment by the commitment of the finance company

Limitations on Sales Contracts

In formulating his sales budget, the manufacturer of consumers' goods is frequently unable to protect himself by means of contracts. Due to frequent style changes, his product may change with each season The sales budget will either be guesswork or, if he sells to the large quantity buyer—chains and department stores—the manufacturer will submit samples and models which may result in orders. On these orders he bases his production For the retail trade which appeals directly to the consumer, advance orders are absent. Few housewives make contracts for their monthly consumption of eggs, milk, butter, children's shoes and household supplies The retailer, on the basis of past experience, may count with reasonable certainty on a given volume of trade, but that trade is, in no sense, legally committed to him. He must rely upon the sales ability of his organization and the quality of his merchandise, to maintain his sales volume. To the retailer, every month's sales are to some extent, uncertainties

Even in the field of industrial goods, and in contracts with wholesale buyers in the consumption goods field, these advance contract commitments are subject to risks. One of the evils of the modern distribution system is the cancellation of contracts, or the demands of buyers for the revision of the terms of contracts The direction of consumer choice is unpredictable. With a multitude of goods and services constantly seeking his favor, the volume of consumer income is subject to hazards, not only because the amount of money in the national pay envelop may sharply decline, but because the expenditure of that money, even by those whose incomes have not been diminished by a recession, is likely to be curtailed by the waves of pessimism which periodically sweep over

the country. All wholesale and manufacturing business is influenced by consumer demand expressed through the retail trade.

During a general business decline affecting a single group of industries, the retail distributors who have contracted in good faith to take a given amount of merchandise, and the manufacturers who, on the basis of these orders, have placed their own orders for merchandise, materials, and machinery, may find all of these calculations upset by some event such as war or a sharp decline of consumer demand In such an event, the question immediately arises, who will bear the loss? A mistake has been made Who will pay for it? The answer always is, "somebody else." If possible, each member of the chain of production, from the raw material to the retail store, endeavors to shift the burden of his mistakes in calculation to his predecessors The retailer cancels his orders with the manufacturer The manufacturer suspends shipments of coal and lumber, and insists upon a revision of the price terms in the contract. Although protected by contracts enforceable at law, although the manufacturer can force the responsible distributor to buy the merchandise which he has agreed to buy, nevertheless, when the buyer requests and often insists, business expediency usually influences the seller to modify the terms of these contracts, to reduce the quantity or the price in a competitive market Of course, if the producer has a monopoly, such as that possessed by the Aluminum Company of America or the International Nickel Company, he may be very stiff in his attitude. As a rule, however, the manufacturer who is faced with a demand for price concessions or quantity reductions, which demand is supported by the known facts of the buyer's business, will weigh the facts carefully before refusing relief If he refuses, the sales in question may be carried out, but he will lose good-will, that lubricant of the sales mechanism, and his future sales will suffer.

A paper box manufacturer had received a contract from a manufacturer of men's accessories, for $75,000 worth of paper boxes. The boxes were manufactured and stored. They carried the purchaser's name and brand. Except as waste paper, they were of no use to any one else. The purchaser was suddenly faced with strong competition. He could not sell his anticipated volume of merchandise He asked the box manufacturer for a concession This was refused on the grounds above stated, that the boxes could not be sold to any one else. The box manufacturer refused to take the loss and forced the distributor to receive the boxes.

The box-maker had been receiving orders from the accessory manufacturer averaging $75,000 a year. These orders ceased. He gained $8,000 profit on the one-year contract in question by forcing acceptance of the merchandise. He lost the buyer's good-will and all future profit by insistence upon the letter of the contract

In 1920 the price of refined sugar fell from 26 cents to 9 cents Wholesalers and chain-stores which had placed large orders with refiners for future deliveries were caught They asked for modifications of these contracts, which, if enforced, would inflict heavy losses upon them One very large refining company refused to make concessions It brought suits against wholesalers to recover on these contracts, and of course, since the contracts were binding, the refiner recovered. Another refiner pursued a different policy In some cases it accepted compromise settlements at reduced prices. It spread payments over a series of years. In one large contract with a chain-store company, this company accepted stock for a large part of the bill. Sugar manufacturing is a highly competitive business Terms of sale and prices are identical Buyers' good-will is all-important. The company which followed a liberal policy is still, twenty years after, reaping the benefits of its enlightened generosity.

The Advertising Budget

Included in, but subordinate to the sales budget, is the advertising budget Some lines of business must advertise from the beginning if they expect to meet the operating expenses, much less show profits There is a famous saying, that if a man can make a better mouse-trap or write a better book, though he make his home in the woods, the world will make a path to his door. If this was ever true, it is true no longer The best mouse-trap can not be sold to the consumer until either the distributor or the manufacturer brings the merits of his product or service to the attention of the buyer. Successful retail distributors of consumers' goods, and most of the manufacturers of consumers' goods, spend substantial sums, based on their realized or anticipated gross earnings, in advertising In the field of producers' goods, however, advertising is of less importance. Here the standard is not the whim and caprice of the customer who will pay more for a branded aspirin tablet, or bicarbonate of soda, or milk of magnesia, than for like unbranded items in the same store The producers of coal, copper, or machinery are dealing with

purchasing agents who are acquainted with the properties and performances of the goods they buy. Their advertising is largely "prestige" advertising, appearing in trade journals and supplemented by "write-up," technical descriptions, sometimes marked "advertising," and sometimes included among the regular articles. These articles bring the merits of the product to the attention of the engineers and purchasing agents. If truthful, even though inspired by business considerations, these technical discussions are effective to stimulate sales.

The Production Budget

Following the sales budget comes the production budget. This is an estimate of the materials, power, labor, and management expenses necessary to produce the goods which can, it is estimated, be sold within the budget period. The production budget also allows for sufficient reserves of materials

In those industries which have one or more peaks of demand during the year, the importance of planning production is noticeable For example, the manufacturer of paper containers which are extensively used to package merchandise sold through retail channels, will have a spring demand peak, culminating a few weeks before Easter, and a second peak ending about the middle of December The manufacturer of containers builds up his inventory of raw materials in ample time to take care of each of these peaks. He also arranges to carry sufficient stocks of standard finished goods to make prompt delivery, not only to his regular customers, but to other buyers who might present rush orders. Not only may demand be seasonal, but the supply of raw material may come into the market within a short time. For example, fruits, vegetables, sugar, or in fact any agricultural product, are harvested within a few weeks. They must be carried either in public warehouses such as for grains and fibers, or they must be carried by the producer himself In formulating a production plan, this irregularity of supply must be taken into account.

Management and Labor Budget

Having provided for raw materials, the next problem is to set up a working organization by which the plant can be operated This organization includes both fixed and variable elements. The fixed element consists of salaries and expenses of management. Executives are hired on a yearly basis. These executives and managers, the new business must

attract by the offer of higher salaries, or by giving desirable men interests in the business, now usually in the form of bonuses based on profits, or options to purchase stock at a low figure Sometimes, when the business is new and growing, desirable men can be attracted to it. The late Walter P. Chrysler, for example, in 1912 entered the employ of the Buick Company He was then the manager of the Allegheny plant of the American Locomotive Company. He had been assured by this company of a salary of $12,000 for the coming year. He went to Buick for $6,000, because he believed in the business, and in his ability to contribute to its advancement At the end of three years, his salary was advanced to $25,000. For the next three years he received a salary of $500,000, a large part of which he took in stock. Aside from this source of executive talent, the new business must rely upon the floating supply of executives, which is recruited by mergers, bankruptcies, and transfers of control.

In estimating labor, several considerations are kept in mind The first concerns the skilled labor. If skilled labor is necessary, for example, die, tool, or pattern makers, or certain classes of full-fashioned hosiery workers, it is often necessary to deal with the union Many unions will furnish reliable help from their unemployed members In other cases, the employers rely on newspaper advertising The employment of one man also leads to the employment of others whom this employee knows. When business is active—and this is the time when new enterprises are usually started—it is often necessary to bid high for help, paying even more than the union scale. With unskilled or semi-skilled labor, the modern industrial system has produced a large pool of labor from which a new business can draw its labor requirements

The labor requirements of modern industries are developing along two divergent lines. On the one hand, highly skilled help is necessary to operate and to keep expensive machinery in repair In this class of help, there is always the danger of scarcity Trade-union rules tend to limit the number of apprentices. In order to maintain an adequate supply of skilled labor, many corporations maintain schools which take the place of the old apprenticeship, where high-school graduates are paid while learning and are given a regular course of instruction, sometimes superior to that given in a trade or technical school, but specialized to that particular business. For example, E. W. Bliss and Company, for many years a leader in the line of stamping machinery and dies, main-

tains a school for young men who are given intensive training in the technique of this business. These schools are staffed by high-paid instructors. E. W. Bliss pays as much as $6,500 a year to its teachers The instruction is of high quality. The students, when their course is completed, are usually placed in the organization. General Electric, Du Pont, and Firestone are other illustrations. This outgrowth of the old apprentice system is now featured by leading companies in many lines.

In concluding this subject of labor, it should be noted that workers do not enjoy the protection of long contracts The standard term of employment is one week, and the rated compensation is on an hourly basis. If orders fall off, or if anticipated business does not materialize, while the permanent staff must be retained, the labor force can be reduced without serious controversy with the union. Labor contracts cover wages, hours, overtime, physical conditions of employment, seniority, and the collection of union dues by the management. They do not guarantee any fixed number of days in the week, weeks in the month, or months in the year. There is visible a tendency to provide this protection for the worker. Procter and Gamble, for many years, have guaranteed from forty-eight to fifty weeks' employment, with two weeks' vacation with pay The Hormel Packing Company in Minneapolis also recently explained the operation of a similar system before a congressional committee. As yet, however, this guarantee of employment which is of course desirable from every standpoint when the conditions of the business permit, is not as yet sufficiently general to modify the long standing rule of flexibility of employment.

The Financial Budget

The third important division is the financial budget The management has estimated its receipts from sales and any other sources which may be available, such, for example, as rentals on property owned, or stock subscriptions. Conceivably included in this estimate, may be the proceeds of any loans for which commitments have been made, which will be received during the year. Against these receipts, are the known disbursements of the company under certain assumed conditions of operation As already shown, some of these estimates of expense are flexible. If the management is disappointed in the volume of sales or in the volume of production and supply, contracts and pay-rolls can be, to some extent, readjusted to meet these changed conditions and main-

tain the margin over expense which is the primary object of management.

The finance budget is adjusted month by month throughout the year The finance officer, comptroller, or treasurer, perhaps the president, estimates his receipts and expenditures as of the last day of each month, reckoning the payments of bills and the disbursements on the various expense accounts, and endeavoring, so far as possible, to have each month show a credit balance. This is, of course, impossible where production is seasonal in nature as, for example, in the canning industry, and where the business must make its profits during a portion of the year, usually running into losses during the lean months.

The management, in this estimate, also provides for capital charges, such as interest, sinking funds, or rentals. Interest and sinking fund are paid, as a rule, quarterly, and rents and royalties monthly. Taxes are paid once a year. It is customary to accrue these annual payments on a monthly basis so that each month will bear its share of the total tax burden, and the management will not be caught unprepared when the day for payment arrives. The same rule applies to the payment of insurance premiums. These fixed expenses are apportioned over the year In substance, the problem of the management is to provide an ample fund of cash, month by month, so that obligations may be met as they fall due.

A new business does not normally expect to show a profit during the first years of operation. Even two or three years may be required, especially if the company runs into a depression during its early life. In the initial financial budget, this fact is realized. It is, of course, desirable that all of these disbursements and charges should be covered by receipts, but it is not always possible, and this contingency must be provided for at the time of the original financial plan.

All Budgets Provisional

The financial plan is always provisional, subject to constant change. Even fixed charges and taxes cannot be accurately forecast, although here the margin of error is less than in the items of production expense. In the expense of production and receipts of sale, wide deviations from the original plan are constantly encountered William S. Knudsen said before a Congressional Committee, in speaking of the 50 per cent decline in the sales of motorcars in December, 1937 "I don't think

anybody in God's world could have told me that the outlook was going to drop 50 per cent in two or three weeks." [1] Similar miscalculations, although not always on such a large scale, are constantly cropping up in a large business A large customer, who regularly discounts his bills on the tenth of the month, suddenly gets into difficulties and takes two or three months. The expected cash is not on hand. Informal promises from banks or large stockholders of some advances to tide over lean periods may not be kept John Wanamaker went to Europe in the summer of 1907 Before leaving he had arranged for loans of $5,000,000 in New York to be made in the fall when large bills fell due He returned in the autumn, at the time of the panic of that year The money was not forthcoming, and he was, for a time, hard-pressed to satisfy his creditors Large orders upon which the management relies, may be reduced or canceled. The management must endure these cancellations, since to resist them would mean the permanent loss of the orders.

A common source of trouble in this connection is a fire or a flood which may throw the production machinery out of gear. Pending the reconstruction or repair of the plant, orders can not be filled. The company must ask the indulgence of its supply people in their shipments to it, and must plead for leniency from its own customers who may be counting on this production, so suddenly interrupted It is customary, under these circumstances of disaster, when the customer can not wait, to shift these unfilled orders to friendly competitors with the consent of the customer, until the damage can be repaired. The number and variations of these business miscalculations is indefinite Suffice it to say, in conclusion, that the management must always, as Edmund Burke once said, submit all their calculations of income "to the moderating influences of a liberal divisor," and apply this same method to their calculations of outlay The financial plan, with its modifications, must provide, in terms of cash, for these mistakes and disappointments.

[1] *The New York Times*, January 7, 1938, p 1

CHAPTER 24

CORPORATION PROFITS

Problems of Financial Administration

Our corporation is now organized and financed It is a "going" concern Immediately a series of problems engage the attention of the management. Without the business man—the manager—the industrial machine would not run In an amusing little play, entitled *Gibson's Upright*, Booth Tarkington narrates the downfall of a piano business whose owner, at the end of his patience, wearied by incessant controversies with his employees over wages and working conditions, makes them a present of the business and retires to await developments At the end of a year the concern is almost dead, wrecked by ignorance and stupidity, and he is unanimously invited to resume control The problems of successful business management are numerous and difficult—organization, personnel, purchasing and planning, advertising and selling, competition and finance.

This study is not concerned with so-called business management, but with the methods of financial administration so far as these have been standardized in the practice of successful concerns. The subjects to be considered under this head are (1) the determination of profits, (2) the financing of maintenance and depreciation, (3) the management of working capital, (4) the distribution of earnings to stockholders

Importance of Accurate Determination of Profits

The corporation income tax makes it necessary for every business to determine its profits Failure to make proper returns subjects the delinquent to penalties Of special importance to the publicly owned corporation from the standpoint of financial management, is the accurate determination of profits The partnership, or the private corporation whose owners are in close touch with affairs, may tolerate, without serious injury, a degree of laxity in the determination of profits If profits are overestimated and either excessive dividends are paid, and/or

the business is too rapidly expanded, it may be possible, by economizing and contracting the scale of operations, to regain a firm position Private corporations and partnerships, moreover, grow out of earnings. They do not appeal to the body of investors, as the public corporation is often forced to do, for funds with which to enlarge their business. Their stocks and bonds are not dealt in on the public exchanges

The stocks and bonds of public corporations which appeal to the investor to provide them capital, are held by institutions and individuals drawing income from these securities. These payments can only be made if the fund out of which they are to come is determined The securities of public corporations, moreover, are usually listed on the exchanges, and are often bought and sold every day. A free market for their securities is of importance. They are enabled by this means to obtain, from time to time, additional sums of money for the enlargement of their businesses. Essential to a free market is accurate information concerning the financial status of the companies issuing securities. Corporation stocks and bonds are deposited with banks and trust companies as collateral for loans Unless essential information concerning the affairs of the enterprise is available, the bank can not safely make large loans.

Publicity of Corporation Returns

It is not only necessary that their profits should be accurately determined by publicly owned corporations, but they should be stated in simple and intelligible form, so the investor and the banker can, without difficulty, reach conclusions as to their earning power and financial condition For a long time, American companies did not recognize the necessity for making such statements of assets and earnings. This condition has long since passed away. The reports of railroad companies, even before the law compelled them to make an accurate determination of their profits, and a statement of their financial condition, left little to be desired The industrial corporations are more remiss in making statements of their conditions. Until the United States Steel Corporation set the example by publishing the first satisfactory report, industrial corporations generally refused to give information, on the ground that disclosure of the condition of their business would give an advantage to their competitors. In time, however, this aversion was worn away by the necessity of obtaining a broad market for their securities, which could not be had without some information upon

which the investor could base his judgment. The reports of industrial corporations are, however, still, as a class, far from being as complete as the reports of the railroads. Public utility corporations generally give less information than do the industrials. Steady improvement in the direction of publicity is, however, everywhere evident. Even if the laws do not intervene to compel full statements of income and expenditures, assets and liabilities, the force of financial opinion may be relied upon to accomplish this result. The listing requirements of the New York Stock Exchange, for example, are particularly full and detailed. They are open to public inspection, and give a complete and accurate picture of the accounts of the largest and most important corporations in the United States, together with a large number of foreign companies.

It is not necessary, as corporation officials have feared, that the amount of information necessary to acquaint the investor with the financial condition of the company in which he is interested, should involve the disclosure of the secrets of the business. This may be illustrated by an instance which shows the possibility of harmonizing publicity for the investor with secrecy as to essential details with which the investor had no legitimate concern. A public accountant was engaged to make a report on a newspaper property which was about to be sold by order of the court. The report was especially full and detailed, but not sufficiently explicit to suit certain persons, who requested information as to the returns from advertising and the amount paid for salaries. The master in chancery refused to allow this information to be given, on the ground that the competitors would discover the secrets of the business. The accountant pointed out, however, that by presenting merely the totals, without mentioning individual items, this danger could be avoided, and at the same time, the investor could be fully informed. The competitors of this paper could not have profited from information as to the aggregate salaries paid, or the total amount of advertising receipts. What they were concerned with was the amount paid to certain employees, and the terms of particular advertising contracts. This information, however, would have been of no assistance to the investor and could easily have been dispensed with.

Profit the Objective of Business Activity

Every business, no matter what type of organization is used, no matter how small the business may be, from newsstand to transconti-

nental railroad, has one objective—to make a profit. The business man may be interested in providing wages for his employees, he may take pride in the excellence of his product and in the rapid increase in his sales. He may, like Henry Ford, advertise his reasonable prices and his superior quality He may dwell upon the public service which he performs He may even claim credit for the large contributions in the form of taxes which he makes to support the different forms of government which periodically lay their hands upon him. All these endeavors are, however, subsidiary to the main chance Every fact with which his business is confronted is examined with reference to this single standard How will it affect my profits? Is the business man asked to recognize the C I O ? Is he requested to give money to a community chest? Is he asked to join in a petition against a government reorganization bill, or a public loan whose proceeds will go to rebuilding or enlarging state institutions? As a business man, he considers all of these matters from the viewpoint of profits.

Profit Concepts

What are profits? Or, more accurately, what does the business man who is endeavoring to make profits consider profits to be? To answer this question we need go no further than the categories of the corporate income tax return to which the business man must conform, and whose financial definition of profits, in the main, he accepts. In 1937, the latest year for which figures are available, 477,838 corporations made reports of their taxable income to the Department of Internal Revenue Of this number, 285,810 showed no net income, and 192,028 reported net income of $9,634,837 This figure was arrived at by the following formula

> Gross sales + gross receipts from other operations + other receipts + [tax-exempt income, and dividends from domestic corporations and interest on tax-exempt obligations], equals total compiled receipts.
>
> *minus*
>
> Cost of goods sold + cost of other operations + interest paid + taxes other than income tax + depreciation and depletion + other deductions, or total compiled deductions
>
> Equals Compiled Net Profit

Subtracting the total compiled deductions from the total compiled receipts, gives the "compiled net profit" This does not exactly correspond to the business man's conception of profits To this final figure on which his taxes are computed, in the determination of what he made during the year, he will add 85 per cent of dividends from domestic corporations and interest on tax-exempt obligations, which were deducted from his income to determine his taxable profit. He will also deduct the corporation income tax which he pays, in arriving, in his own mind and for the purpose of his own calculations, at the amount which he calls his profit

The formula which is generally followed for the calculation of profits includes the following elements common to every business (1) the amount of sales, less discounts and returned merchandise, (2) the cost of sales, which includes materials and supplies, labor, superintendence, taxes other than income taxes, insurance, depletion, depreciation, and bad debts The balance (3) when (2) is subtracted from (1), is the net operating income. To this figure is added (4) other income, consisting of rentals, royalties, interest, dividends, or any other income derived from sources outside of the main activities of the business, but which is a regular source of income. The result of this addition is (5) gross corporate income From this gross corporate income are deducted all fixed charges, rentals, royalties, income taxes, and interest Deducting this total from the gross corporate income gives (6) net corporate income, or, as it is called, balance available for dividends, or balance carried to surplus account.

This is the profit of the corporation This net corporate income is added to the earned surplus of the corporation. To this earned surplus, which represents the accumulations of profit from past years, is added non-recurring income recoveries on bad debts, which had been written off as uncollectable, federal or state tax refunds where taxes have been overpaid, and sales of property no longer needed for the business. The result is total surplus. From this total surplus are deducted any extraordinary losses incurred during the fiscal year from such causes as uninsured losses from riots, fire, flood, or other acts of God, losses on the sale of property at less than its book value, and inventory losses. The balance is the amount available for dividends, and (7) dividends paid on all classes of stock are next deducted The final balance (8) is the undistributed balance in the earned surplus account, as of the end of the fiscal year.

Income of the American Tobacco Company

This method of determining the profit of a corporation may be illustrated by the consolidated statement of income and surplus for the year 1937 of the American Tobacco Company

CONSOLIDATED STATEMENT OF INCOME AND SURPLUS FOR THE YEAR 1937

Sales, less trade and cash discounts, returns and allowances	$242,644,514.69	
Cost of sales, selling, general, and administrative expenses	211,113,292 53	
	$31,531,222 16	
Add		
Dividends from American Cigarette and Cigar Co, whose income is principally dividends and rentals from the American Tobacco Company	1,496,868 46 *	
Dividends from other wholly or partly owned subsidiaries not consolidated herein	1,253,102 72 *	
Other dividends and interest	268,411 86	
Other income	277,037 20	$34,826,642 40
Deduct		
Interest, discount, etc.	$876,432 64	
Other losses and expenses and provision for reduction in valuation of other investments	257,267 60	
Premium on six per cent bonds purchased and canceled	1,000 00	1,134,700 24
Net, before depreciation, state and federal taxes, etc.		$33,691,942.16

*Dividends received in 1937 from subsidiaries not consolidated herein include $1,478,681 60 in common stock B of the American Tobacco Company and exceeded by $310,000, the net income for 1937 of such subsidiaries applicable to the investment of the American Tobacco Company (earnings of foreign subsidiaries converted at constant rates of exchange which result in a lesser amount than if converted at prevailing rates)

CONSOLIDATED STATEMENT OF INCOME AND SURPLUS FOR THE YEAR 1937—*Continued*

	Carried forward	$33,691,942.16
Deduct		
Depreciation	$1,191,511 44	
State franchise and income taxes	1,275,964 44	
Federal income and capital stock taxes	4,737,062 80 **	7,204,538.68
Net before flood casualty loss		$26,487,403 48
Deduct		
Flood casualty loss		289,910 45
Net income		$26,197,493 03
Deduct		
Four quarterly cash dividends of $1.50 each on six per cent cumulative preferred stock		3,161,982.00
Balance added to surplus account		$23,035,511 03
Surplus, as per statement December 31, 1936		59,922,811 52
		$82,958,322 55
Deduct		
Cash dividends on common stock and common stock B		
March 1, $1 25 a share	$5,929,810 00	
June 1, $1 25 a share	5,929,810 00	
Sept 1, $1 25 a share	5,929,821 25	
Dec 1, $1 25 a share	5,929,825 00	
	$23,719,266 25	
Less cash dividends on common stock and common stock B in Company's treasury	785,080 00	22,934,186 25
Surplus, December 31, 1937		$60,024,136 30

** No provision made, or believed to be required, for federal surtax on undistributed profits

There is, in the above statement, a deviation from the sequence presented in the general discussion of profit determination. The American Tobacco Company statement shows that, after arriving at net income which is normally the balance available for dividends, the company made a deduction from the year's net income of over $3,000,000, which represented the regular dividend disbursement to preferred stockholders. We indicated that the net income would first be added to accumulated earned surplus before any dividend disbursements would be made. The probable reason why the American Tobacco Company first deducted preferred dividends from 1937 income, and then added the remainder to previous surplus before deducting payments made to common stockholders, was the fact that the four quarterly dividends to the common stockholders aggregated $22,934,186.25 net.

There is a growing tendency for American business corporations to present their income statements in this form. There are, of course, variations in the order of accounts. Since the passage of the Securities Act of 1933, all corporations offering securities to the public in interstate commerce are required to furnish the Securities and Exchange Commission with complete financial data over a period of years. In filing their registration statements, they must present this information in a form acceptable to the Commission. The form which they require is practically the same as that given, although it frequently provides for greater detail.

The Economists' Conception of Profit

It will be interesting to compare the business management's concept of profits with that of the economist. The manager of the corporation identifies as profit that amount of unexpended income which is available for the payment of dividends. The economist has a conception of pure profit which tends to correspond to this figure. He considers pure profits to be any surplus earned by the enterpriser above ordinary interest on his own capital and ordinary wages of management. To find the equivalent of this definition on the corporate income account, we should first deduct from net corporate income, for any given year, all dividends paid. If there remains any balance carried to the accumulated earned surplus account, such an amount would be pure profit. We must assume that all costs of production, all compensation to capital,

all wages of management, have been deducted from the income of the corporation in arriving at the balance carried to surplus. Referring again to the American Tobacco Company's statement given above, it appears that for the year 1937, the company showed no pure profit. The combined preferred and common dividends exceeded the net income for the year. Whether or not the economist will agree with this conclusion will depend upon what he considers the rate of return which each of the stockholding groups in the American Tobacco Company should have as proper compensation for the use of their capital. If 6 per cent dividends on the preferred stock represents a fair return for the use of the preferred stockholder's capital, then the preferred stockholder has received no pure profit By the same reasoning, if he feels that 4 per cent is adequate compensation to the preferred stockholders, then the 2 per cent additional which was paid them in dividends would be pure profit. The same reasoning might be applied to the common stockholders and the dividends which they receive.

There are few corporations whose securities are widely held, where the larger portion of the capital stock, as it now stands, represents contributions of capital by stockholders on which, in the economist's view, they are entitled to a reasonable return which corresponds roughly to that which the capitalist could obtain by investing his money in risk-free form in savings-bank deposits or high-grade bonds or mortgages These public corporations, as we have already shown, start with an initial contribution by stockholders. This is the almost universal rule As the business prospers, these stockholders draw dividends which may or may not contain elements of pure profits They also receive, from time to time, additions to their shares which represent the capitalization of pure profit retained in the business and employed to increase its earnings and assets

In 1916, shortly before the creation of its successor (the General Motors Corporation of Delaware), the General Motors Company of New Jersey had outstanding preferred and common stocks amounting to $31,497,000, the equivalent of which was presumably contributed by stockholders in the various companies which had been consolidated into the General Motors Corporation It appears, from examination of the General Motors Corporation balance sheets given by Moody, that since 1916 the company issued a total of $108,857,831 of preferred and

common stocks, either for cash or in exchange for property. There were frequent changes in capitalization, such as reduction of par value, elimination and restoration of par value in varying denominations with respect to common stock On this total stockholders' contribution of $140,354,-831 the company has paid in cash dividends, $1,817,775,000 up to 1937 If we deduct 4 per cent interest on the stockholders' capital contributions for the years since 1909, when the first cash dividends were paid on the stocks of General Motors Company of New Jersey, which is approximately the amount they could have received throughout this period without risk, there is a balance of over $1,716,000,000 of pure profit which has been received by the stockholders of the company. This enormous return was obtained by reinvesting $565,246,000 of income in the business which itself represents pure profit, according to our definition

A similar situation is presented by every prosperous, publicly owned corporation The greater part of the return to the stockholders in American corporations consists of pure profit, recognized as such by the economist, and a very small amount of compensation is the contribution of capital

The foregoing Consolidated Statement of Income and Surplus of the American Tobacco Company shows a balance to the Surplus Account as of December 31, 1937, of $60,024,136 30. Of this total, there was contributed for the year 1937, $101,324 78. In order to obtain the actual profits for the year 1937, to the amount of $101,324.78 there must be added the total amount of dividends declared and paid upon the outstanding cumulative preferred stock, $3,161,982.00, and the cash dividends declared and paid on common stock B, outstanding in the hands of the public, or $22,934,186 25. The total of these three figures represents the net income of the company for the year 1937, which is $26,197,493 03.

Balance Sheet Method of Determining Profits

There is available for use another method of ascertaining the profit of the American Tobacco Company for the year 1937. This involves the comparison of the items contained in the balance sheet of the company as of December 31, 1936 with the corresponding items from the balance sheet of 1937 Such a comparison is as follows

Assets	Dec 31, 1936	Dec 31, 1937	Increase	Decrease
Cash	$19,501,908 43	$21,365,946 79	$1,864,038 36	
Accounts receivable, customers	10,917,418 83	11,492,584 08	575,165.25	
Other accounts and notes receivable	2,155,661 16	1,646,319 29		$509,341.87
Leaf tobacco, manufactured stock, operating supplies, etc , at cost	121,152,007 94	137,422,278 99	16,270,271.05	
Accounts receivable from subsidiary and affiliated companies	523,981 09	1,527,721 44	1,003,740 35	
Total current assets	$154,250,977 45	$173,454,850 59	$19,713,215 01	$509,341 87
Investments				
Capital stocks of partly owned domestic and wholly owned foreign subsidiaries	24,516,534.55	24,269,551 81		246,982 74
Other investments, at amounts not in excess of cost	2,401,828 85	2,064,240 06		337,588 79
Mortgages, loans, and accounts receivable	1,287,289 76	909,808 96		377,480 80
Real estate, machinery, fixtures, etc , at cost, less allowance for depreciation	17,609,382 87	17,696,179 96	86,797 09	
Prepaid insurance, etc	1,246,110 76	1,528,967 68	282,856 92	
Brands, trade-marks, patents, good-will, etc	54,099,430 40	54,099,430 40		
	$255,411,554.64	$274,023,029.46	$20,082,869 02	$1,471,394 20

Liabilities	Dec 31, 1936	Dec 31, 1937	Increase	Decrease
Notes payable to bank, Feb 1, 1937	$1,663,000 00	$21,697,000 00	$20,034,000 00	
Subsidiary company acceptances payable	97,623 75			$97,623 75
Accounts payable	1,615,886 24	1,982,448 49	366,562 25	
Dividend on preferred stock for quarter ended Dec 31, 1936, payable Jan 2, 1937	790,495 50	790,495.50		
Interest accrued	338,558 96	324,378.73		14,180.23
Provision for advertising, taxes, etc	6,091,288.18	7,316,505 51	1,225,217 33	
Accounts payable to subsidiary and affiliated companies	101,081.63	377,937 67	176,856.04	
Notes payable to bank, maturing in '38 and '39	3,436,000 00	1,739,000.00		1,697,000 00
Serial debentures				
3¼%, maturing Feb. 1, 1940	1,792,000 00	1,792,000 00		
3½%, maturing 1941 to 1948	16,740,000.00	16,740,000 00		
6% bonds, maturing Oct 1, 1944	131,650 00	126,650.00		5,000 00
4% bonds, maturing Aug 1, 1951	831,250 00	831,250 00		
Scrip and Convertible dividend certificates not yet presented for redemption or conversion	7,624 00	7,324 00		300 00
	$33,636,458 26	$53,624,989 90	$21,802,635 62	$1,814,103 98
Capital Stock:				
Preferred, 6%	52,699,700 00	52,699,700 00		
Common stock, both classes	109,152,584 86	107,674,203 26		1,478,381 60
Surplus	59,922,811 52	60,024,136 30	101,324 78	
	$255,411,554 64	$274,023,029 46	$21,093,960 40	$3,292,485 58

The net increase in the assets as shown amounts to $18,611,474 82, and the net increase in the liabilities other than the surplus account is $18,510,150 04. The difference between the increase in the assets and the increase in the liabilities, $101,324.78, is the amount by which the surplus or net worth of the company has been added to during 1937. When the amount of the cash dividends declared and paid are added to the increase in the surplus, the resultant figure will be $26,197,-493 03

After comparing the reconciliation of the two balance sheets with the net income figure shown by the Income Account for the year 1937, the reader will notice the basis for the statement that "corporate profit is represented by the increase in the net worth of a given business between two consecutive statement dates"

Additional Sources of Profits

So far we have discussed but one source of corporation profit, the operation of the business. Corporations may derive profit from three additional sources first, the sale of stocks and/or bonds at a premium, second, the sale of corporate assets at prices in excess of the figure at which these assets are carried on the books of the corporation, and third, upward revaluation of company assets Each of these types of corporation profit will appear on the corporate balance sheet, but will not be shown in the income account of the corporation for the year in which the profit was made.

Let us consider each of them in turn. Assuming that the stock has a par value of $100 per share. The corporation may issue additional shares at a time when profits have been substantial. The stock, as a result of these profits is selling above par value, and the company receives, in payment for the additional shares issued, a sum of money greater than par. When the additional stock is added to the capital stock liability appearing on the balance sheet, the number of new shares, multiplied by $100 a share, will represent the increase in capital stock liability Since the corporation received a number of dollars in excess of the aggregate additional capital stock liability, a surplus has been made which should appear on the liability side of the balance sheet under the caption, "Paid in Surplus." This is a tangible thing, since dollars equivalent to the surplus as shown, plus the par value of the shares issued, came into the possession of the company and appear in the

assets of the company While this surplus was acquired in the form of money, it may not be found in the cash account Subsequent to the date of acquirement, a portion or all of it may have been expended for various types of assets, or in the payment of expenses, or in the reduction in other liability accounts

When, as frequently happens, a company sells certain assets no longer needed, for example, real estate or machinery, or securities, the price obtained may exceed the cost or book value. Here again the company receives dollars which normally pass through the cash account, but may not be found there, on the statement at the end of the year for the reasons given in the preceding paragraph. However, a surplus has been derived It is customary to show this surplus under the heading of "Capital Surplus" on the liability side of the balance sheet

Finally, a corporation may create a form of surplus which coincides with the definition of corporate profit, by writing up the book value of certain assets For example, after a number of years of successful operation and rising price levels, the management may discover that current market values for real estate and improvements substantially exceed the original cost of the land plus the buildings, after allowing for loss in the value of the buildings due to a number of years of use. To verify this opinion, the management will engage an appraisal company which will fix a current value for the asset by studying recent real estate sales in the neighborhood, and will also determine the "reproduction new" cost of the building. The appraisal figure may substantially exceed the book value of the real estate and plant account. The company is not selling this asset, because it is still essential to the corporate purposes, but the effect of the appraisal is to increase the excess of asset value over total liability, which we have already defined as corporate profit. Here there has been no effect upon the income account for the year in which such an appraisal was made. The corporation has received no dollars, nor have they expended any, they have simply altered the relationship between assets and liabilities as they appear on the balance sheet.

The goals of management are (1) to keep its plant and equipment in satisfactory operating condition, (2) to provide against losses due to improvement in the art of its particular type of manufacture or trading, or due to changes in consumer's demand; (3) to compensate all those elements which have contributed to the production of its product, such

as labor, management, (4) to meet its tax bills, (5) to pay dividends on its stock, and (6) to accumulate adequate surplus. The last contributor to receive his compensation is the common stockholder Before we can consider the question of dividend distribution, there are certain problems of financial management which must be examined. These problems are first, the management of working capital, second, the management and maintenance of plant and equipment, and third, the management of depreciation and obsolescence and contingent reserve. The quality of managerial judgment in the solution of each one of these problems determines the amount of profit which the company will earn.

CHAPTER 25

FINANCING OF MAINTENANCE

Operating expenses are divided into two classes (1) those incurred in utilizing the plant in the production of goods or services, and (2) those incurred in keeping the plant in condition for effective operation In the statement of railway operating expenses there are five classes (1) maintenance of way and structure, (2) maintenance of equipment, (3) conducting transportation, (4) traffic, and (5) general expenses While industrial corporations—at least in their public statements—do not break down operating expenses in so much detail, in their own accounts the same methods are followed, sometimes, of course, under different names Of these five classes, returning to the break-down of railway operating expenses, (1) and (2) are maintenance, (3) and (4) operation, and (5), general expenses, are divided among the other four The nature of these maintenance expenses in railway operation may be understood from the items included under each classification The largest items under maintenance of way and structure are track maintenance, road-cleaning and ballast, rails and ties, buildings and grounds, and track expenditures In this classification are recognized (a) the cost of labor and minor superintendence, and (b) the cost of materials Under maintenance of equipment, the largest items are repairs of locomotives, repairs of passenger and freight cars, and repairs of tools and machinery Here, again, the division between labor and materials can be made Contrasted with maintenance is the cost of conducting transportation, solicitation and receipt of traffic, movement to destination, and its delivery to the consignees Under the item "conducting transportation," we find the following principal items station service, road-men, road engine men, firemen, fuel for locomotives, engine-house men, trainmen, telephone and telegraph. Again, these expenses may be divided into money paid for labor and minor superintendence, and materials, the largest item of materials being fuel

Here is shown the distinction between the cost of maintaining the road and the cost of operating. The cost of operation need not further

concern us Its principles and methods have no special significance for the subject of corporation finance. The cost of maintenance, however, for the public corporation which is organized to produce dividends often for many thousands of stockholders, and, in many companies, to produce interest for bondholders as well, is a matter of peculiar significance in interpreting financial operations.

Standards of Maintenance

The maintenance of physical property involves the following (1) the establishment of certain standards of physical condition which may be either printed in books of rules or may exist only in the minds of foremen and superintendents, (2) the expenditure of money on labor, appliances, and materials, in order to keep the property in a condition corresponding to this standard. A standard, for example, for a railway track is a description of the track and roadway as it ought to be, in other words, an ideal which the maintenance of way department is constantly striving to attain, but which, while they may never fall far below, they never quite reach A typical specification is as follows

Ballast There shall be a uniform depth of six (6) to twelve (12) inches of well-broken stone, or gravel, cleaned from dust, by passing over a screen of one-quarter-inch mesh, spread over the roadbed, and surfaced to a true grade, upon which the ties are to be laid. After the ties and rails have been properly laid and surfaced, the ballast must be filled up as shown on standard plan, and also between the main tracks and sidings where stone ballast is used All stone ballast to be of uniform size, the stone used must be of an approved quality, broken uniformly, not larger than a cube that will pass through a two-inch ring On embankments that are not well settled, the surface of the roadbed shall be brought up with cinder, gravel, or some other suitable material.

Similar standard specifications exist for every part of the railroad's property

It is the duty of the maintenance departments to see that the property is kept in this condition. Many forces are constantly at work to lower these standards The pounding of heavy trains throws the track out of alignment, grinds the ballast to powder, wears the rails, especially on the curves, and loosens the spikes and fish-plates. And while the locomotives and cars are destroying the track they are destroying themselves. Wheels become worn, frames loose, paint wears off, glass is broken,

boiler tubes are filled with scale, furniture and fittings become dirty and dingy. While the running of the trains is doing all this damage, nature is at work upon the roadway Rain, sun, frost, and running water are constantly wearing it away Water seeps into the ties around the spikes, carrying in bacteria and fungi, and in time the wood decays. In the spring, when the ground thaws, the track is lifted and wrenched out of line and surface. Erosion is filling up the ditches and damming up water which settles around the ballast and helps on the disintegration of the roadbed. The ballast, from its own weight and that of the track and trains, settles into the ground. Sunshine, wind, and rain unite to destroy paint and timbers. Frost makes rails and fastenings brittle. All these agencies of destruction are constantly at work to pull down the road below its established standard The maintenance of way department is always at work building it up again. In all weather, at all hours, the maintenance gangs are at work upon the property. The task is never done They never approach its completion The standard is never reached. All that can be done is to keep it in sight. Perfection is unattainable.

Maintenance of equipment is handled in a different manner The basis of equipment maintenance is mileage. An elevated railway car, for example, may be assumed to run 6,500 miles before it needs attention. When that mileage is reached, the car is put in the shop for repairs. Or an inspection system may locate bad order cars, or each part of the car may have a predetermined mileage, at the end of which it goes into the shop to be overhauled Here, in the largest industry, that of transportation, is shown the problem which confronts every business, that of maintaining a physical standard. Every man has the same problem. His personal appearance, his physical fitness, lie at the foundation of his earning power Let him neglect his diet, his exercise, his dress, let his moral standards deteriorate, and almost immediately his efficiency as a productive agent declines So, in the field of production, incessant care and unwearying vigilance are necessary if the standard, the ideal, is to be maintained

An additional illustration of maintenance will serve. A flour-milling company submits the following Each miller carries a small notebook and during his half-hourly inspection of the plant makes a note of everything that needs attention These memoranda are then transferred to a maintenance record and left on the head miller's desk. Every

Sunday morning three of the men go over the record If a bearing shows signs of working loose or a sieve in one of the sifters shows wear, it is noted on the record and repaired. The first miller attends to all the belting, testing the belts periodically and tightening them when necessary A millwright is employed for part time to repair spouts and elevators. Once a week all the sifters are inspected, brushed, and the silks are repaired. At regular intervals the rolls are changed, and the worn rolls are shipped away for recorrugating Breakdowns, as a result of incessant care and watchfulness, are of rare occurrence

When improper maintenance endangers human life, the state steps in, as in steam-boiler inspection, and it insists on safety appliances, and enforces rules. In the coal-mining industry, an extra hazardous business, maintenance standards are prescribed by law In Pennsylvania coal-mines, for example, "on all haulage roads, the track, roadbed, and required clearance shall be kept clean and free from obstructions, such as lumps of coal, slate, lumber, rails or other materials over which men may stumble." "The track shall be properly aligned, and shall be free from high or low joints, broken rails, defective switches, defective frogs and frog-joint alignments Roadbeds shall be kept well drained and properly surfaced" In every industry progressive management is standardizing maintenance.

This matter of adequate maintenance is of increasing importance with the growing substitution of machinery for hand labor. A large modern works is a complicated machine, not merely a building housing a large number of laborers. Neglected scale in the boiler tubes may cause a leak and shut down the plant. A broken engine governor may stop a coal elevator and so close a factory. A broken shaft in a large powerhouse, for which no spare part was available, closed a number of coal-mines for several days Even so small a matter as neglect to replace worn-out packing in mine pumps may cost five hundred men a day's pay and make a large reduction in tonnage. Paint, repair, replacement, abundance of spare parts, incessant vigilance, are necessary to keep a plant in serviceable condition.

Distinction between Maintenance and Betterments

Maintenance includes a second division called betterments. This is sometimes classed with additions, but, since it relates to plant standards, it is considered with maintenance We have explained that a standard of

maintenance is a description of the physical condition of the plant as it ought to be. A betterment expense is one which established a new standard. Examples of betterment expenditures from the railway industry, the most familiar and accessible source of information, are the substitution of stone for gravel ballast, of masonry embankments or steel bridges for wooden trestles, replacing light rail with heavy rail, lining tunnels with brick or concrete, creosoting ties, elevating tracks, and like improvements

The size of the plant has not been increased by betterments. It is no larger than before. It has, however, been improved and is more efficient Stone ballast drains better and gives a firmer support to the track Heavier trains can be run over a stone-ballasted track at higher speed Such a betterment not only reduces operating expenses but increases gross earnings Other familiar illustrations of betterments are the substitution of heavy structures and machinery for lighter apparatus

Results of Failure to Maintain Property

There is a rule which determines the extent to which the condition of physical property may be allowed to decline As long as the unit continues in service and its deterioration does not effect the condition of connected units, it may be restored to its original condition at a comparatively small expense. If, however, the impairment in condition extends to property either connected with the undermaintained unit, or operating in connection with it, the expense of renewal may be great.

For example, a power line is run through porcelain insulators suspended from rocker arms, and these in turn are attached to wooden poles. This line may be undermaintained. These insulators are continually being broken. The broken sections should be promptly replaced. It sometimes happens that, because of lack of funds, this replacement is not made. In an electrical storm, the insulators may not be able to protect the poles from lightning, which they are supposed to do when in normal working condition, and a large number of poles may be destroyed, putting the line out of commission The result is a large outlay for replacement. A high-speed trolley wire may last a long time before it is necessary to replace it Deterioration in a trolley wire is due to crystallization which may be far advanced before it breaks When the break finally comes, it may occur ahead of the car or train instead of behind it. In that case, the current may burn up the electrical equipment in the car.

The receivers of a high-speed electric line had reduced their maintenance to the lowest possible point consistent with regular operation The traffic was heavy. When the time came that maintenance could no longer be deferred, it was decided to put the property in its original condition The receivers asked for estimates by a firm of construction engineers. After examining the property, the engineers reported that twice as much must be spent to replace the property as to build it new The reasons for this apparently extreme statement are interesting When the line is first constructed, there is no traffic to interfere with the work. It can be carried on in the daytime without overtime, night work, or Sunday work. When, however, the line is renewed while remaining in operation, the costs are multiplied. It is necessary to do the work at night. Night work, even when done under electric light, is less effective than day work. A large part of the labor must also be paid time and a half, or double time Even when work is done at night, the interruptions of traffic are serious, and the clearance given to work trains is short A large part of the available time must be spent on side tracks, waiting for an opportunity to continue work on the main line

To illustrate this point from another field, a man can overmaintain his teeth. He can have them cleaned, all cavities filled, dead teeth removed and replaced by artificial teeth, and he can be released from the dentist's chair for a long period. During this time, of course, tooth caries are developing and tartar is accumulating The state of the dentition is declining. Not until it reaches the point where decay sets up functional disturbances is it absolutely necessary again to seek the dentist When this point is reached, if immediate attention is not given, if the teeth are not restored to good condition, the result of neglect will have spread so far into connecting tissues and bony structures that the costs of restoration may include not only the deferred dental maintenance, but may require surgery and long-continued medical treatment, far beyond the cost of normal dental care.

Relation of Maintenance to Volume of Business

A large part of the expense of operation varies with the volume of business An increase in the traffic of a railroad means more trains, and more employees to run the trains and to keep them in repair A falling-off in traffic shows a corresponding reduction in the cost of conducting transportation. The same is true of all industries. The cost of operating

the plant, as distinct from the cost of maintaining it, fluctuates with the amount of business done.

In the maintenance items of operating expense, however, a certain amount of variation is possible, to adjust outgo to fluctuations in income. Maintenance charges, as we have seen, contain two items: the cost of upkeep and repairs, and the cost of betterments, intended either to raise the standard of construction and decrease the cost of maintenance or operation, or to increase the capacity of the plant. The rule which governs the management of the first class of maintenance expenses is that, so far as possible, standards of maintenance, once established, should be adhered to. Maintenance should be a comparatively fixed expense, varying only as the influences which affect the wear and destruction of the property change.

Adherence to this rule permits fluctuation in the amounts of annual appropriations for upkeep. The cost of railway maintenance of way, for example, is increased by an open winter which results in greater damage to the track and roadway by alternate thawing and freezing. It is increased by the high cost of labor and material incident to business prosperity, and also by the heavy traffic which results from large production in prosperous times. Maintenance cost, on the other hand, is reduced, without injury to the property, during periods of depression. When traffic is light, the wear upon the track and the amount paid out in wages are lessened. The efficiency of labor is also increased at such a time, not merely because workmen are more anxious, by diligence, to commend themselves to their employers and so retain their positions, but also because track work is not so much interfered with by passing trains. The cost of materials is also lower during periods of depression.

The maintenance of plant or equipment not directly affected by weather conditions can also be reduced during depression without injury to the property. A large amount of substitution of parts, such as air-brake hose, and belting, can be made during a dull season, when only a portion of the plant or equipment is in operation, thus reducing the cost of maintenance. A case in point is a factory manufacturing leather goods, which had normally four floors in operation. In a dull year, business fell off so that only the machinery on the one floor was used. As fast as the belting wore out on the lower floors, belts were transferred from idle machines, where they would have deteriorated, and were put into use. Such economies of maintenance do not involve a lowering of

the standard of the plant, although, when the entire plant is again operating, the cost of replacement may be greatly increased to restore the equipment used up in this manner Railway companies, during periods of reduced traffic, usually curtail their equipment maintenance without serious damage to the property. In recent years, for example, the anthracite industry has been severely depressed and shipments have declined All the anthracite carriers reduced their equipment maintenance. Cars were stored on sidings Locomotives were coated with grease and allowed to stand idle. Shop forces were reduced Expenditures for repair materials, for example, air-brake hose and brake shoes, fell off.

We come now to the management of maintenance appropriations in order to compensate for fluctuation in the volume of business and the amount of profit Large American corporations are, in the last analysis, controlled by investors Our industrial system is organized to pay interest and dividends, first, to those persons who have contributed capital to the upbuilding of these companies, and second, to their successors and assigns. The justification for this system is that without it, it would be impossible to raise capital for the development of industry. The contention of stockholders and bondholders is that interest and dividends must, if possible, be paid. As long as these payments are made, they are content If dividends, however, are sharply reduced or passed, stockholders grumble and management is criticized. If interest is not paid, the company must be reorganized by the creditors or by the court. In view of this situation, the financial policy of publicly owned corporations, which are forced to appeal to the investor for capital funds, is, to a greater or less extent, subordinated to the necessity of paying dividends. Where interest exists, financial policy is subordinated to the necessity of paying dividends and interest. Corporation profits are subject to wide fluctuations These fluctuations are (1) seasonal, (for example, the railroads have always made most of their profits during the last six months of the year, during the first six months they are fortunate to clear operating expenses), and (2) cyclical, varying between periods of business activity and periods of business depression.

Example of Maintenance Management

We may illustrate this point from the railway industry. Instead of the consolidated figures for the entire industry, we shall take the record of the Pennsylvania Railroad, the largest and strongest railroad cor-

poration, whose practice in all departments has always been considered as standard

The years 1927 to 1929, inclusive, was a period of prosperity for the Pennsylvania Railroad The amount available for fixed charges, which in 1921, at the trough of the depression, was $75.5 millions, had increased in 1927 to $146.7 millions, and in 1929 it stood at $181 5 millions, the highest point ever reached. The maintenance expenditures in 1927 were divided as follows Maintenance of way and structure—$87 9 millions, maintenance of equipment—$140.8 millions—a total of $228.7 millions. Figured on a mileage basis, this was $8,365 per mile for way and structure, and $13,399 per mile for equipment. This amount had varied but little since 1924, by which time the company had recovered from the post-War depression. It changed very little between 1927 and 1929. The property was being adequately maintained, and the amount spent did not vary materially. Then followed the depression of 1930-193—. The amount available for fixed charges decreased by the following sums—comparing each year with the year preceding

1930	$34.7 millions
1931	49 2 millions
1932	3.2 millions

The total figure stood in 1932 at $94.4 millions, a decrease of $87 millions in three years Then it increased, but at a very low rate, and in 1936, at the peak of recovery, the amount available for fixed charges of the Pennsylvania Railroad was $118 3 millions, which was $63.2 millions below the figures of 1929 In other words, the Pennsylvania Railroad was far from recovering its 1929 earnings To make this showing of earnings, which even in its decline is the largest figure shown by any large railway company, the Pennsylvania not only reduced its cost of conducting operations from $234.3 millions in 1929 to $151 4 millions in 1936, but also found it necessary to make very heavy reductions in its maintenance expenses. The total maintenance, taking the years of severe depression, when railway operating revenues declined from $682 7 millions in 1929 to $331.3 millions in 1932, declined from $229 4 millions to $91.6 millions—a total of $137.8 millions. Expressed on a mileage basis, the decline was from $8,357 to $2,429 in way and structure per mile, and from $12,523 to $5,993 in maintenance

of equipment. Without this decrease in maintenance, it would have been impossible for the Pennsylvania to remain solvent In 1929, it earned its fixed charges 2 26 times, and in 1932 only 1.17 times If the maintenance of 1929 had been spent on the property in 1932, the company would have fallen short of earning its fixed charges. Comparing this sum with the amount available for fixed charges in 1932, $94 4 millions, would have left the Pennsylvania $43.4 millions short of the amount necessary to pay its interest and rentals The company would have been insolvent During the same period, the Pennsylvania reduced its dividend rate from 3.875 per cent to .5 per cent. Of course, the payment of even this small dividend was made possible by the heavy reduction in maintenance expenses

It has been shown that operating expenses decline during a depression As the amount of freight and passenger traffic decreases, the number of trains, the amount of fuel and other supplies, and the number of employees decrease also. For example, on the Pennsylvania from 1929 to 1932, the number of passengers carried decreased from 113,713,000 to 61,000,000, the number of tons of revenue freight carried decreased from 233,000,000 to 104,000,000; and the number of tons carried one mile decreased from 49,174,000,000 to 25,200,000,000 This was a decrease in traffic of approximately 50 per cent Total operating expenses during the same period, responding to the decrease in volume of work to be done, declined from $493.1 millions to $242 millions, a decrease corresponding roughly to the decline in traffic The greater part of this decline in expenses, so far as the cost of conducting transportation is concerned, follows from the reduction in traffic It is also affected by reductions where wages are not fixed by contract with the railway labor unions, and even here, a maximum reduction of 10 per cent was secured Costs of coal, oil, and the operating materials were also reduced In general, however, the cost of conducting transportation varies more closely than any other element with the volume of traffic In industries where labor is not organized, the management can more readily offset a decline in sales by a reduction in wages. When, however, we come to maintenance expenses, we find that the directors can go much further in the direction of offsetting a decline in revenue by a decrease in expenses than the amount of reduction which is naturally permitted by a decline in business

Maintenance, which has been defined as an expenditure of money to

maintain a certain standard of the railway plant, as, in the opinion of the engineers, it *should* be, to attain maximum efficiency at lowest cost, involves two elements first, maintenance made necessary by wear and tear in operation; and second, maintenance made necessary by external conditions, notably weather conditions [1]

It is well within the truth to ascribe 35 per cent of the wear and tear of railway property, including way and structure and equipment, to the weather, and 65 per cent to the wear and tear of operation. Assume, now, a decrease of 50 per cent in traffic and a corresponding decline in the number of passenger and freight-train miles The amount necessary to maintain these two classes of railway property in good operating condition on the basis of standard specifications would be reduced by 32.5 per cent, while 67.5 per cent would remain as a fixed charge against revenues. All that management can do in saving in maintenance expense without lowering the standard of the property is confined to 32.5 per cent of the maintenance.

Applying these figures to the reduction in maintenance of the Pennsylvania from 1929 to 1932, we find the permissible reduction, without impairing the efficiency of the property, to be $71.3 millions, while the actual reduction was $137.8 millions, leaving the property undermaintained by $66.5 millions This combined maintenance remained low for 1933, standing at $89.1 millions In 1935 and 1936, however, with the revival of traffic, maintenance rose to $102.6 millions in 1935 and to $141.6 in 1936, approximately corresponding to the increase in train mileage, although showing a smaller ratio to gross than in 1929. There is no evidence that the directors of the Pennsylvania abused their discretion over maintenance expenses. That is, they did not require a reduction of maintenance expense to a point which would impair the operating efficiency of the road

To understand how maintenance can be reduced below the permissible level of efficiency without danger to the economical functioning of the property, requires further analysis. The best maintained property in the United States, by common consent, is that of the American Telephone and Telegraph Company. Assuming an ideal condition of the property "new" or 100 per cent, this company maintains it at 80 per cent, which is the utmost possible figure which can be attained The best

[1] This division, of course, relates only to day-to-day maintenance, and not to betterments, which will be considered separately

endeavors of this organization, which at no point skimps or defers the maintenance of its property, falls short by 20 per cent, of perfection.

Assuming that the standard of maintenance of railway property can be reduced to 50 per cent before efficiency of the property suffers, and that the maintenance of the Pennsylvania Railroad in 1929 was 70 per cent of the maximum, there is a margin of 20 per cent within which maintenance can be reduced. It is within this further 20 per cent that the directors of the Pennsylvania Railroad Company could reduce their maintenance without impairing the efficiency of operation. To illustrate, comparing 1929 with 1932, it was shown that the property had been undermaintained by the amount of $66.5 millions However, giving consideration to the 20 per cent margin explained, the permissible reduction would have been increased by $43 8 millions, and the undermaintenance decreased to $22 7 millions, when measured by the operating efficiency standard.

A large part of the reduction in maintenance cost is caused by throwing out of service certain portions of the property which are not required by the reduced scale of operations, and which need not, therefore, be maintained The New York Central, for example, during the worst of the depression, did not utilize two of its six tracks between New York and Buffalo Except in the case of serious damage, such as washouts, it was not necessary to maintain these unused tracks. Furthermore, it was the practice of this, as of other well-managed railroad companies, to spend very liberally during periods of large earnings upon their track and equipment They bought many heavy and costly locomotives, purchased large numbers of new cars, relaid their track with heavier rails, painted and repaired their structures from one end of the system to the other, and when the storm of the depression hit them, they were able to sharply curtail all kinds of maintenance, without seriously impairing the efficiency of the property

A large part of these pre-depression expenditures were betterments. A betterment contributes to the earnings of the company in one or both of two ways it either reduces the cost of maintenance, or it enables a larger volume of business to be handled with the same equipment In the railway field, for example, when a company relays a large amount of its track with creosoted ties and replaces gravel and cinder ballast with crushed stone, replaces 80- to 90-pound rails with 125- to 130-pound rails, relays curves where the wear on the rails is the most severe

with alloy steel material, replaces brick or timber lining in tunnels with concrete, and concretes the tunnel roadway at the same time, it is not only fitting the track to carry a heavier traffic load, but it is also reducing the cost of maintaining this improved roadway. Companies like the New York Central, the Baltimore and Ohio, and the Pennsylvania spent large sums from 1923 to 1929 on betterments They were preparing the way for a sharp curtailment of maintenance when such a course became necessary They took the fullest advantage of this opportunity to economize when the depression came upon them.

Test of Maintenance Adequacy

An available test of the adequacy of maintenance is furnished by the number of derailments in reference to the train mileage. For the New York Central the figures are as follows

Derailments		*Train Mileage during this Period (000,000 omitted)*	
1929	214	1929	3,135
1930	157	1930	2,725
1931	161	1931	2,353
1932	148	1932	1,937
1933	132	1933	1,951
1934	143	1934	2,000
1935	129	1935	2,005

Here was a reduction from 1929 to 1932 in train mileage of 36 per cent, and a reduction of derailments of 39 per cent Measured by this standard, the operating efficiency of the property did not suffer

Deferred Maintenance Accumulates

On all this property, assuming that former levels of traffic are to be attained when business revives, this reduction in maintenance, due to the throwing out of service the track and equipment not needed to move the business, must be made up The buildings which remained unpainted during the depression, the platforms which were allowed to rot, the ties which were not replaced because they were not subjected to wear, the rails over which no trains ran, and the locomotives and cars which stood idle on side tracks, all must be repaired when they are put into service Neglected maintenance adds substantially to the cost of

repairs when these are eventually made. The stitch-in-time rule applies throughout for the cost of maintenance The expense of regular and systematic maintenance is much less than where a long-neglected plant is completely overhauled and repaired. A familiar example is the recognized economy of regular painting. One coat of paint applied every five years means four paintings in twenty years If the painting is omitted for ten years, it will need three coats of paint to put the surface again in weather-resisting condition.

Financing of Betterments

The discretionary control of betterment expenditures, however, was used to the fullest extent The financing of betterments is approached from a different standard. The preservation of a standard once established is a characteristic of efficient management. Within limits this condition may be allowed to decline The limit is the maintenance of operating efficiency To raise the standard, however, which betterment expense does, is usually another matter Betterment expenditures properly wait upon the convenience of revenue. A plant must advance and improve, or it will go backward This is the law of industrial life. But the advance need not be continuous Long periods of stagnation may intervene when betterments and capital additions are postponed, when the business conserves its energy, completes work undertaken, and gathers strength for a new start The rule to apply to the solution of such problems is the rule of common sense which does not permit the spending of money which is not in hand or in sight.

Generally speaking, American railroads, with the exception of such favored properties as the Norfolk and Western, the Chesapeake and Ohio, and the Virginia Railway, whose earnings, based upon the transportation of premium coal, did not seriously decline, spent little money upon betterments during the depression Thus betterment expenditure has not shown any substantial increase up to the end of 1937. Money was not available, either from reserves or from the sale of securities If and when railway traffic again increases, then some part of the resulting increase in earnings will be devoted to an improvement of the property Until such time comes, however, the railway managements are not to be criticized for neglecting to spend money which they do not have, and which they can not obtain

On the other hand, great executives like Harriman and Carnegie con-

centrate the betterment expenditures of their companies into periods of dull business, when materials are cheap, labor abundant, and betterment work can be done with the least disturbance to operation. Since it demands the accumulation of money during flush times for expenditure during dull seasons, this policy can be adopted only by companies of great financial strength. A general adoption of this policy would furnish partial cure for periods of business depression. Indeed, it was recommended for this purpose by Herbert Hoover when Secretary of Commerce, especially in reference to public works, as a means of reducing the fluctuations of industry and trade. Mr. Hoover advocated a considered policy of building roads, public buildings, and other improvements when the general trade is dull, reducing unemployment and replacing some of the reduction in demand for commodities by the expenditure of public money. Its adoption on a large scale, however individually and socially desirable it might be for public companies where management must pay heavy fixed charges, and if possible, some dividends, must be placed far in the future. Betterments as well as additions, for the public company, must continue to wait upon revenues.

Capitalization of Betterment Expenses

Our final inquiry concerns the capitalization of betterment expenditures. By capitalizing an expenditure is meant charging, that is to say, adding its amount to some asset account, with a corresponding addition to some liability item, such as surplus, or reserve for additions and betterments or capital stock or bonds. The effect of a policy of capitalizing betterments, therefore, if long continued, is to inflate the assets and give a false idea of the value of the enterprise. Since 1907, this obligation to capitalize all betterments, adding the increased cost to the new asset, for example, 100-pound steel rails, over the depreciated value of the displaced asset, 60- or 70-pound rails, to the asset account, and showing a corresponding increase in liabilities, has been the rule of the Interstate Commerce Commission. Every company subject to its jurisdiction must capitalize the cost of all betterments.

This is, we believe, an error, although not one likely to be soon corrected. The basis of asset value is not cost but earnings. Many betterment expenditures fail to materialize in net earnings, or if they increase earnings, the increase is below the standard rate, 6, 8, or 10 per cent, on the expenditures. By "standard" rate is meant that rate of return on

investment which is required before money will be spent, either out of profits, or out of the proceeds of stock or bond sales In the early days of the Standard Oil Company, 35 per cent was required to be shown before money would be appropriated for improvements. During the depression the "standard" rate of return which had to be shown before any capital outlay was authorized, in one of the large oil-refining companies was 100 per cent. Public utility companies whose profits are limited to a "reasonable return" are of necessity satisfied with a return of 6 or 8 per cent If an improvement can show the standard rate of return, it can properly be capitalized at its full cost Any deficiency below the standard rate should result in a reduction in the amount capitalized In case the demand for the service or commodity calls for an increasing supply, an addition to the plant may increase earnings. Conservative financial procedure is to charge the cost of all betterments to maintenance expense. If the betterment proves profitable, either in reducing expenses or increasing gross revenue, it is well, but if not, as may happen, then no harm is done and false hopes of distribution and "melon-cutting" are not raised The Interstate Commerce Commission of that distant period believed that many railroad companies were "burying" their earnings in betterments as a satiated and thrifty dog gives his surplus bones temporary interment, and that in some way, not clearly disclosed, at an opportune time, the concealed profits would be dug up and given to the stockholders

In justice to the Commission, we must admit that, while insisting on the capitalization of betterments, it has left the railroads free to account for this capitalization by crediting any liability account they please Some companies have increased their surplus account Others have set up reserves in the manner described in the next chapter

If now, in concluding the discussion of this subject, it is desired to capitalize betterment expenditures, what is the proper basis? Evidently a conservative estimate of the earnings' contribution of the betterments, the capitalization of an annual increment of earnings on the basis of a certain number of years' purchase We may, for example, capitalize $50,000 a year as $500,000—ten years' purchase—in a well-established industrial, or as $250,000—five years' purchase—in some specialty factory The basis of capitalization is not the cost of the betterment but the returns from the betterment The same rule applies to additions A capitalization of cost without reference to return leads to inflation. If

one betterment costing $10,000 shows a 10 per cent saving, while another shows 5 per cent, and if the basis of capitalization is 10 per cent, the first may be capitalized at $10,000, while the capital value of the second, based on its income, should not exceed $5,000, the remaining $5,000 being charged to profit and loss. An indiscriminate capitalization of betterments, without careful inquiry into the increase of earnings from each expenditure, will result in the inflation of assets and is, in effect, the capitalization of expense.

The Stitch-in-Time Rule of Maintenance

The rule followed in maintaining a plant is that "a stitch in time saves nine" The expense of regular and systematic maintenance is much less than where a long-neglected plant is completely overhauled and repaired. A familiar example is the recognized economy of regular painting. Neglect of maintenance, for any reason, is likely to be followed by serious consequences The operating efficiency of a plant is so closely related to its physical condition, and the success of its business is so dependent upon its efficiency of operation, that serious damage may be inflicted upon a company by failure to maintain its physical standards

A good illustration of the consequences of neglecting maintenance is furnished by the fifth annual report of the Kansas City Southern Railway Company, for the fiscal year ending June 30, 1905 The capital stock of this company was originally vested in a voting trust for five years from April 1, 1900. The voting trust expired by limitation on April 1, 1905, when the stockholders came into possession of their property and elected a new board of directors. They found the road in such a condition as to be practically unfit to carry on the business of transportation 25 per cent of the engines were in bad order, 65 per cent of the freight equipment was unfit for use in the transportation of grain, merchandise and other freight demanding dry cars, 55 of the 65 per cent required heavy repairs; tie renewal had been neglected, ditches had not been cleaned, sufficient ballasting had not been done, and sufficient rails had not been laid. The condition of the ties and wooden structures and track, as a result of the neglect of maintenance, was so bad that it was impossible to move trains at ordinary speed. During the six months from January 7 to June 30, 1905, as a result of the impaired condition of the property, there were 715 wrecks and derailments reported, each of which was of sufficient magnitude to require a special report and

therefore cause serious loss and delay. Such a great number of accidents could not fail to cause serious loss of the confidence and good-will of the public, and consequent diversion of traffic, also destruction and damage to property, delay to trains, and resulting wasteful expense for extra fuel and overtime of employees [2]

During the month of May, 1905, overtime paid engine and train crews amounted to $8,311.28, although the average of overtime for the three years preceding, before the property had reached its worst condition, was $5,990 88. In addition, large amounts were paid each month for labor in rerailing cars and engines, and for repairing track and equipment as a result of derailment due to defective tracks. Large amounts were paid for loss and damage to freight due to such derailments Finally, the company suffered severely in competition for business because of its inability to take all the traffic which might have been obtained, and also because the traffic which it did move was often seriously delayed in delivery and arrived in bad condition.

We see, in the case of the Kansas City Southern, the effect of the neglect of maintenance upon operating efficiency, and the effect of decreased operating efficiency upon traffic and earnings While this is an extreme case, it illustrates a principle which is of invariable application To allow a property to run down is to impair the property's efficiency and to inflict serious injury upon the operating company.

Waste of Deferred Maintenance

We have given this subject of deferred maintenance such extended treatment, not only because it describes the maintenance policies of regulated companies which must include the facts and fluctuations of maintenance in their reports, making them available for study, but because by understanding these policies we can appreciate the vicious extravagance of undermaintenance Well-managed corporations *never* neglect maintenance. They *never* allow the physical efficiency of the property to decline. In good times and in depression, their plants are kept in good repair Dividends may be reduced, pay-rolls may be cut, the execution of expansion plans may be deferred, but repairs and necessary renewals by these well-managed enterprises are not neglected or deferred Deferment of maintenance, as already shown, is

[2] Fifth annual report of the Kansas City Southern Railway Company, fiscal year ended June 30, 1905

costly. Huge sums have been lost by such neglect Bondholders have received their interest—out of the property This deferment has been made good from the larger earnings of good times, but if good times do not return, as with many of the railroad companies, even the senior bondholders must wait outside for their interest, in the cheerless atmosphere of bankruptcy, while the interest money is devoted to making up the arrears of maintenance Deferment of maintenance to pay interest reverses the natural order. It places fixed charges ahead of the health of the profit-making mechanism It is often undertaken as a counsel of desperation in order to ward off default Less often, in these days of repentance and improved financial behavior, is maintenance reduced in order to maintain dividends. If (a not unreasonable assumption), the replacement of deferred maintenance costs 50 per cent more than adequate and persistent maintenance, and if the amount of deferred maintenance during a three-year period of depression is $1,000,000, then when this maintenance is replaced the excess cost will be $500,000, $166,000 per year It would be better to borrow the money, if a loan can be made, and keep up the plant, than to allow its condition to run down and then to replace it at such an expense.

CHAPTER 26

MANAGEMENT OF WORKING CAPITAL

In every business there is a man whose duty it is to sign checks. He pays supply bills, draws checks for pay-rolls, salaries, rentals, taxes, interest, and dividends. Out of the company's bank account, under his guidance, flows a stream of disbursements, rising and falling with the seasons and the volume of business, but never ceasing Upon this official —call him treasurer, comptroller, what you will—also rests the responsibility of replenishing the reservoir of cash which is constantly running away His task, supremely important, is known as the management of working capital

The management of working capital centers upon the preservation of the cash balance To this end, goods must be first produced, sold, and the proceeds promptly collected Profitable production, quickly and regularly sold is essential But if the sales are not made to responsible persons, the goods are given away If the proceeds are not promptly collected, the concern is always struggling in debt incurred to meet current expenses, which prompt payment of receivables would have made unnecessary All this is trite and commonplace but often neglected

The operations of every business follow the same general course, sales are made, the goods and services are produced to supply this demand, in return for these sales, either cash is received or a credit account is opened, and finally, these accounts receivable in the process of collection, are turned into cash. This process is known as the circulation of working capital from cash through production, delivery, and collection, to cash again If the business prospers, the result of this process is to increase the cash receipts By this process of increasing cash through turnover of working capital, the operating profit of a business is produced

The primary objective in the management of working capital is to provide an amount of cash sufficient, at all times, to meet the claims upon the treasury Wages must be paid either weekly or fortnightly, salaries monthly, supplies and power bills monthly, taxes and insurance

annually, interest monthly, quarterly, or semi-annually. The treasurer has always before him a "tickler" which shows the payments which must be made during the next week, month, and quarter. With these payments he compares the amount of cash which he will need for the different items, to make sure that there is a comfortable margin on the right side These bills must be paid. The cash must be in the bank to pay them. It is the treasurer's business to see that this cash is provided.

If the business is on a cash basis, such for example as railroads—cash for passenger service and 96-hours for freight bills—restaurants, food, variety and drug chains, and amusements, if the volume of sales shows little seasonal variations, and if the sales exceed the cost of producing those sales, there is no serious problem of working capital Large bundles and bags of cash are delivered, at the close of each day's business, to the company's depository, and out of the resulting deposit credit, payments are made. The same may be said of service industries that operate on a monthly credit basis, such as public utilities. They are usually considered to be on a cash basis. When enterprises are on a cash basis, the management of working capital presents few difficulties.

Cash Capital Affected by Changes in the Volume of Business

The outlays of many business enterprises are subject to wide fluctuations. These fluctuations may be seasonal, for example, the sales of agricultural machinery which are largely concentrated in the spring and early summer, and the wholesale sales of canned goods which follow the packing season in the fall. In the Christmas holiday season, the greatest retail demand is concentrated. Preparation must be made months in advance to supply the holiday trade In many lines provision must be made for the future demands conditioned by the weather or other seasons. For example, retail coal-dealers buy a large part of their coal supply during the late spring and summer months, in order to be prepared for the fall demand. The producing companies, in order to encourage these early purchases, give substantial discounts for spring buyers which are passed on to the retailers' customers The automobile demand is largely concentrated in the spring and early summer. Dealers increase their inventories of cars and parts in anticipation of this demand.

Some lines of business show extreme variations of cyclical demand The construction industry, for example, during some years, is operating at capacity. The capital of the building companies is fully employed. This was the case between 1922 and 1926 Following 1926, however, with the exception of certain large cities, the construction industries rapidly declined, and have not since revived to their former volume Certain machinery manufacturers—like the Mesta Machine Company and the E W. Bliss Company, which specialize in machinery for certain purposes, such as the continuous rolling of steel—execute single orders running as high as $15,000,000.

Other companies, for example Foster Wheeler, which specializes in oil-refinery equipment, also receive single orders running into the millions These orders can not be regularly counted on. Long months and sometimes years of preparation are required to get them While they are very profitable, they are not often repeated. The demand for the products of a business of this kind is very irregular. In addition to regular operating expenses, provision must be made for disbursements, already enumerated, to the state and creditors Every well-managed company has, moreover, a development program, including improvements of existing plant or additions to plant capacity This program is laid out to cover a series of years. Contracts are made with outside concerns, covering the completion of these improvements. These contracts, once started, can not be suspended. Although, at the time they are made, the current receipts of the business over operating expenses may have been considered sufficient to meet the contract payment, yet a cyclical decline in profits may have thrown these calculations out of balance, and raised a working capital problem for the management to handle.

Preservation of the Cash Balance

We have already shown that the object of a working capital policy is the preservation of the cash balance In the face of the frequent and wide variations between seasons, and between years, in the cash receipts, how may these cash balances be built up and sustained? There are two methods by which the cash balance of a business enterprise can be maintained. The first involves the use of the company's credit, the second requires the permanent provision of a sufficient amount of cash to provide for any probable calls upon these resources.

The first method is that employed ever since the beginning of the capitalistic system This policy may be summed up in one sentence—when a business man needs money he should borrow it The business man in all ages, up to the limit of his capacity, has followed this rule. Assuming that his business is profitable, and that the ratio between current assets—cash, marketable securities, inventory of raw materials, goods and finished merchandise, customer's accounts and bills receivable—and current liabilities, meets the standard set up by lending institutions, and if those lending institutions are in funds at the time, the business man applies for a loan. He can and does, from time to time, and sometimes all the time, borrow such sums as he requires to make up any discrepancy between his cash receipts and the demands upon his cash balance.

This money is borrowed on various terms and with various forms of security contracts A concern in good credit, with a five to one ratio of current assets to current liabilities—obligations maturing within one year from date—may borrow on its single-name paper without any other security than the right of action that the holder of any obligations has against a borrower. Large corporations have no difficulty in obtaining bank loans for any legitimate purpose, to buy materials, to pay interest, even to pay dividends. These loans are either secured by collateral, or they anticipate the proceeds of collections and other receipts. When companies, however, are small and weak, they must often supplement the company's own credit by endorsement of directors upon their paper The company may borrow on the credit of those who purchase the goods which it produces This credit it may utilize, either in the form of a draft drawn by the seller and accepted by the buyer which makes the bill when honored by the buyer, two-name commercial paper, or the accounts receivable resulting from sales may be pledged by the seller to secure loans from a bank or instalment finance company. Finally, the company may borrow on the collateral security of commodities or merchandise which they may own, pledging the titles to this merchandise in the form of warehouse receipts as collateral security. The second method of providing working capital is to build up, either out of profits withheld from dividends, or by capital contributions, a fund of current assets, so that in the normal conversion of one kind of asset into another, sufficient cash will always be on hand, based on past operations, to meet emergencies.

Justification of Bank Borrowing

It is profitable for a business enterprise to borrow money to meet seasonal, occasional, and exceptional requirements for money. Thus, by utilizing his credit, the business man can turn his sales into cash, establishing a kind of revolving fund in the bank, out of which he makes his disbursements, and into which his receipts are poured His own capital may be invested in his plant, and a part of that capital may have been borrowed by the sale of long-term bonds On this part of his capital he may be paying 5 per cent interest, while earning 20 per cent. An example is furnished by the bank borrowing of the instalment finance companies.

The business man may supply only his permanent working capital from his own resources or from the proceeds of long-term loans, relying upon his various sources of credit for emergency funds when occasion arises The business man may usually rely upon the bank to handle such situations, in full confidence that the banker will take no advantage of him, will work with him, and help him with advice, information, and assistance, for example in renewing loans which it is more convenient not to pay at maturity, and carrying endorsed customer paper which is being reduced by instalments. American bankers are always anxious to cooperate, so far as they may do so with safety, with their depositing borrowers

This statement of American banking is contrary to a belief which was formerly more widely held than it is at present, namely, that if a loan is made on valuable security there may be danger of what the courts call "oppression," the forcing to sale of property by a lender—not primarily to obtain his money, but to get possession of property at a low figure by means of judicial sale In 1918 one of the writers was in the office of the Central Trust Company of New York, waiting for an interview with an official The late James N Wallace, President of the bank, was at his desk. A very ancient man, far up in the eighties, entered His name was taken to the President who called him over. After some conversation, the President sent for the loan clerk, then he came over to the Vice-President's desk with the remark, "There is nothing too low for some people to do" The facts were these This man had as his sole means of support a small number of shares of an unlisted stock which was paying a substantial dividend, but for

which there was a very narrow and inactive market This stock he had pledged for a collateral loan up to a moderate portion of its value. An official of the bank which had made the loan, learned of this situation and had the loan called. The old man was at his wits' end, because his entire income came from the difference between the interest on his loan and the dividends on the stock. If it was forcibly sold, he would be wiped out. In his extremity, he recalled that many years before, he had been a depositor in the old Central Trust Company, and appealed to the President to help him out. The loan was taken in and the situation was relieved This is an exception and not a typical case, but it is upon such instances, occasionally occurring, growing more sinister as they are repeated, that the legend of bank oppression has been built up.

Such cases of conspiracy to "oppress" are unusual. To say nothing of the natural aversion of decent men to such shady and disreputable practices, most large borrowers have friends and connections and would resent any form of "trover, subreption, and conversion" by which any of their friends and associates would suffer loss Banking is a highly competitive business Bankers must guard their reputation for fair dealing. In the famous case of Willett vs Herrick, where certain prominent financiers of Boston and New York were convicted in a civil suit of conspiracy to appropriate property of the plaintiff by the oppressive use of bank loans, the plaintiff had, apparently, no "friends" He had been an ardent reformer, was regarded by the business interests as an undesirable citizen who should be liquidated, and it seemed safe enough to practise upon him. Unfortunately for the reputation of the conspirators, the plot was thoroughly ventilated, and the huge verdict of $10,000,000, even though subsequently reversed on technicalities by the State Supreme Court, will for years act as a wholesome deterrent to proposed variations from the path of righteousness.

As already stated, these occasional cases of oppression, compared with the millions of bank loans which are each year being made and paid, furnish no ground for believing that a solvent and reputable business man or corporation need hesitate to replenish depleted working capital by bank loans, especially since the control of all forms of banking has been tightened by amendments of the Banking Act in the early 1930's. It would not now be safe, even if it might be profitable, for a banker to invite the critical attention of the public authorities to shady practices

Interest

Another objection to bank loans may be raised—interest—sometimes 4, usually 5 or 6 per cent, sometimes much higher. As one veteran business man, inarticulate but struggling for adequate expression, put it. "Interest eats, interest eats, it eats like everything" This view requires attention True it is, that borrowing, for men of good credit, especially when possessed of collateral, is easy, and repayment of loans, while more difficult, involving, as it does, the pain of parting with money, is well within the borrower's ability. If the proceeds of the loan have been productively expended, or if made in anticipation of known receivables, or to anticipate the receipts of business which long experience shows will almost certainly be realized, the repayment of the loan becomes almost automatic. Money flows out of the bank's funds into the borrower's account and, after a period, flows back through the borrower's account into the bank's possession, to be again advanced to borrowers in a never-ending revolution of advances and repayments. But this service, valuable though it always is, indispensable though it may sometimes be, is not free service. Banks and trust companies in the United States receive incomes from lending. Even at existing low rates they collect substantial sums of interest from commercial borrowers How can the payment of these sums be justified? Would it not be well, in case some alternative method could be devised, to escape this burden?

Quick and vigorous is the response to the objection The bank lends money, let us say, at 6 per cent. The business man takes the money and makes 8, 10, or 12 per cent He shows a large profit on the transaction, and since the bank is not lending the money of its stockholders, but in large part its own promises to pay which serve as money, both parties to the transaction profit.

We have before us a report of a scrap-iron business whose working capital is $12,500 This business is irregular, prices showing wide fluctuations. During dull seasons, the company buys large amounts of scrap, which can then be obtained at low prices, with the expectation, based on long experience, of selling this material when the steel business revives, at an average advance of 20 per cent. About $50,000 was borrowed for this purpose during the last depression. Interest charges amounted to $3,000 and profits to $10,000, leaving a net gain of $7,000

made on the borrowed money. More familiar illustrations are furnished by the loans made to take advantage of cash discounts Most lines of merchandise grant cash discounts of 2 per cent Sometimes, however, the discount terms are much more liberal, rising to 4 per cent, and even as high as 7 per cent in exceptional cases If a concern expects to pay its bills within a ninety days' limit in any event, by borrowing $5,000 for this period, which will cost $75, and taking advantage of the cash discount, a profit of $25 is shown. If the terms of payment are less than sixty days, and the discount terms more liberal, the profit on borrowing for this purpose is increased We have already seen the advantage to the concern doing a seasonal business—such as a fertilizer or agricultural machinery company, in using the banks' funds for a part of the year when its own money, in case it should provide enough cash capital to finance its business without resort to the banks, would bring only the low rate paid on bank deposits. There are also the opportunities which come to every business to make purchases on especially advantageous terms This money can be borrowed and show a large profit over the interest cost An intelligent use of his bank is properly regarded as one of the most essential qualifications of the successful business man.

Practices of Successful Corporations

We must concede the force of this argument It is strong and well supported by familiar facts. It remains to examine into the practice of the largest and best managed corporations, to determine the extent to which they avail themselves of the lending facilities of the banks in supplementing their working capital

We should expect to find in these companies a general resort to credit, for they are the favored borrowers. Their stockholders and directors are dominant factors in the largest banks. Their credit is unquestioned Bank loans to any amount they could advantageously use, would be instantly placed at their disposal, and these loans could be carried indefinitely. And yet, we find that, contrary to their evident advantage, apparently choosing the expensive path, the largest corporations, with few exceptions, are not borrowers, do not use the unlimited bank credit which they possess.

First comes Henry Ford. He is the largest and probably the most successful business man in the world. To accumulate one billion dollars

of property in twenty-four years is a feat beyond parallel. Nothing resembling or remotely approaching this performance has ever been known. Beside this extraordinary accumulation, considered merely as a heaping up of riches and saying nothing of the methods by which the result was accomplished, the achievements of Carnegie, Morgan, Harriman, even of Rockefeller, are inferior. These men were favored by opportunity. They worked with powerful groups of financiers and politicians and business men. They had every resource and device of accumulation at their disposal. Some of them, notably the Rockefeller group, profited enormously from the appreciation in the value of properties taken over at low prices in satisfaction of loans. Others, like Mr. Harriman, were masters of the stock exchange. Others, like Mr. Carnegie, took advantage of a favorable conjunction of circumstances to double their fortunes almost overnight. Mr. Ford, however, has had no powerful associates. He seems to dislike associates. He bought them out as soon as they became valuable. He shuns the stock exchange. He has operated on a scale of prices, which, with the exception of the war period, has gone steadily downward. To make this enormous fortune in twenty-four years by simple manufacturing and selling entitled Mr. Ford to rank as the super business man of all time. Even his worst enemies can not deny him the crown. And yet, Mr. Ford has never borrowed from banks. He does not believe in borrowing. He is outspokenly opposed to it. He has issued purchase money notes, but, if we may trust his own statement, he has never borrowed money, and a 1931 statement of the Ford Motor Company showed a cash balance of $372,483,105, breaking all records for "idle" capital. Mr. Ford's aversion to borrowing did not extend to his dealers, who are heavy borrowers, and Mr. Ford has helped them borrow by scattering his cash among the dealers' banks. For himself, however, he has always sold for cash and his example has been generally followed by other automobile manufacturers.

Let us go to the opposite extreme. John D. Rockefeller and his associates were successful business men. One of the Vanderbilts stated publicly that the Standard Oil group were the "brightest" set of men he had ever known. In Mr. Rockefeller's *Random Reminiscences of Men and Events,* he describes his early struggles. He was a great borrower. He borrowed all he could get and asked for more. He had to buy and hold oil, and the banks furnished the money. And yet to-day,

as for many years past, the Standard Oil Companies, formed out of the company founded by this great bank borrower, do not borrow from banks. An examination of their balance sheets shows enormous holdings of liquid assets, moderate amounts of accounts payable—they are all buyers of oil—but practically no items which can be interpreted as bank loans, or commercial paper. When a Standard Oil Company needs additional working capital it sells bonds or preferred stock. Banks would gladly lend at lower rates than have been paid, but the Standard Oil does not borrow.

The United States Steel Corporation, the Westinghouse Electric and Manufacturing Company, the General Electric, the American Locomotive, the Allied Chemical, International Paper, American Woolen, American Sugar, Anaconda Copper, American Smelting and Refining—nearly all the leading industrials and railroads are small borrowers. Heavy borrowing among the large industrials seems to be confined to the meat-packers, the fertilizer companies, the manufacturers of agricultural machinery and automobiles, and the large mercantile undertakings. Other companies, with few exceptions, show very small note-payable items among their liabilities. They provide working capital either out of profits or by the sale of securities.

Insofar as we can derive a rule of practice or a tendency of policy from the practice of these large companies, it is that sufficient working capital should be provided out of earnings or from the sale of securities and that bank borrowing should be resorted to only in emergencies.

Decreasing Importance of Commercial Loans

Automobile companies—an explanation of their independence of banks—exact cash payments for their cars from the retailer, who attends to the necessary financing of instalment purchases. Sometimes, as with the General Motors Acceptance Corporation, the parent company promotes a company to assist the dealer, and the large cash balances which these companies carry are of assistance in securing liberal treatment from banks The tendency here, however, is a universal tendency. In building materials, including steel, in staple foodstuffs outside of canned goods (particularly in meat products), in all products of agriculture; in the metal industries, throughout the export trade—the tendency is to shorten the credit and secure the cash. Even the rapid growth of instalment selling does not affect the producer. The burden is placed

upon the distributor, as described above. The commercial bank, as a source of working capital for business, is rapidly losing ground. A recent computation showed that only 18 per cent of member bank loans were available for rediscount, that is to say, were classed as commercial loans, and the percentage is steadily decreasing. Banks lend many billions on collateral mortgages, bonds and stocks, commercial products, real estate, instalment contracts, but the old-time commercial loan on single-name or endorsed paper, based upon the reputation of the borrower and supported by his liquid assets, is losing ground. Business is now mainly done on a cash or short-credit basis, and from present appearances it will not be long before the commercial loan in bank portfolios will be reduced to a position of minor importance.

A study of the short-term borrowing of 151 corporations from 1919 to 1936, inclusive, based on end-of-the-year balance sheets, shows the following by groups [1]

1.	No borrowing	23
2.	Bank loans of $10,000,000, fairly consistent borrowers	31
3.	Bank loans of less than $10,000,000 in less than half of the years examined	62
4.	Bank loans of less than $10,000,000—consistent borrowers in more than half the years examined	35
		151

The group of non-borrowers included the following companies

Alpha Portland Cement Co	Eastman Kodak Co.
American Brake Shoe and Foundry Co.	General Baking Co
American Can Co	Gotham Silk Hosiery Co.
American Car and Foundry Co.	Kennecott Copper Co.
American Chicle Co.	S. H. Kress Co.
American Locomotive Co.	National Biscuit Co
American Smelting Co.	Parke, Davis and Co
Bethlehem Steel Co.	Timken Roller Bearing Co
Bon Ami Co.	United Fruit Co.
Burroughs Adding Machine Co.	Ward Baking Company
Corn Products Refining Co.	F W. Woolworth Co.

[1] From a study made by the Finance Honors Seminar, Evening School of Accounts and Finance, University of Pennsylvania, 1939

The total borrowings, year by year, of the three groups of borrowing companies, and the total borrowings of all borrowing companies, appear in the following table, in which the amounts are stated in millions (00,000 omitted).

Year	*Group 2* Large Borrowers	*Group 3* Small Borrowers Occasional	*Group 4* Small Borrowers Consistent	Total Borrowing
	$	$	$	$
1919	586.6	31.6	57.1	675.3
1920	688.0	86.4	85.1	859.7
1921	422.3	42.4	75.2	539.9
1922	241.7	32.0	56.1	329.8
1923	278.0	37.4	71.0	386.3
1924	192.1	17.6	70.2	280.0
1925	164.5	8.7	79.8	253.0
1926	136.6	21.6	77.7	236.0
1927	150.4	23.3	70.3	243.9
1928	180.0	14.3	73.3	267.6
1929	234.8	37.6	77.8	350.2
1930	148.0	34.0	62.7	244.6
1931	139.0	34.0	33.3	206.0
1932	145.0	19.6	27.8	192.3
1933	145.7	13.4	30.3	189.4
1934	176.8	6.7	27.6	211.1
1935	184.0	22.5	24.5	231.9
1936	135.8	29.7	25.0	190.5
% decline	76.9%	6.0%	56.2%	71.8%

This table will repay examination. We observe, first, how great has been the decline in total borrowing—from $859,700,000 in 1920, to $280,000,000 in 1924. During this brief period, the banks lost most of their profitable business. And they have never regained it. In only one year, 1929, did the total reported bank loans of these 128 borrowing companies go as high as $350,200,000, little more than one-third of the average bank loans of 1919-21. We may note also that, while bank loans rose moderately in 1929, a year of large business, they declined in 1936, another year of large business. The evidence is plain that these corporations, as a class, do not mainly rely upon banks to furnish their working capital. The percentage decline in all groups is about the same.

A comparison of the largest borrowers in the second group in 1920, the peak year, with the figures of 1929, is revealing

	1920	1929
	Millions of Dollars (00,000 omitted)	
Armour	148.9	23.5
Swift	94.6	
Cudahy Packing	33.5	10.3
United States Rubber	49.4	
Gulf Oil	21.2	.9
Goodrich Rubber	29.1	2.9
International Harvester	11.8	
United States Steel	31.2	
Pacific Mills	12.0	
Sears, Roebuck	44.5	
Du Pont	26.2	
American Sugar Refining	34.0	

If we eliminate the meat-packing companies, the other companies borrowed only 3.8 millions in 1936. In Group 3—small occasional borrowers—only Allis Chalmers, Celanese, Hershey Chocolate, National Cash Register, National Lead, and Standard Oil of California reported bank loans over $2,000,000 in 1936, and only the last-mentioned company reported as much as $5,000,000.

In group 4—consistent small borrowers—the largest loans were made in 1936 by Budd Manufacturing, Crucible Steel, American Rolling Mills, Glidden, American Radiator, Austin Nichols, and Standard Sanitary. These companies had the borrowing habit and their borrowings were substantial. The remainder of the group in 1936, if they borrowed, repaid their loans during the year. Considering the assets and earnings of these companies, their bank borrowings at the peak of the recovery period, at a time when bank credit was literally going begging, were insignificant

The conclusion is indicated, on the basis of the available evidence (loans contracted and paid within the same year are not reported) that borrowing from banks, as a means of providing working capital, is not only of decreasing importance, but of small importance. When interest rates were high during the early twenties, bank loans were common

and they were large. Interest rates remained high until 1930 and bank borrowing fell to low figures. Since 1935, interest rates were unusually low, sometimes less than 1 per cent for strong borrowers, but these rates did not produce, on any large scale, applications for loans

Reason for the Growing Disuse of Borrowing

It is not difficult to understand the aversion of the business man to long-term borrowing. Every depression brings a multitude of corporation defaults which could have been avoided if long-term corporate debt had been restricted Bank borrowing, however, stands on a different basis. It is made either against good collateral with a safe margin of security or in anticipation of the proceeds of bills and accounts receivable whose maturity will furnish the means to pay the bank loans. Why then, since the current objection to bank borrowing has been shown to be baseless, should the business man desert the bank? Why should he finance his own working capital needs when it would be safe and profitable for him to borrow money for a large portion of these requirements?

The answer to this question, so far as it can be answered, goes back to the depression of 1920 and 1922 This depression, compared with the recent business debacle of 1930 and 1933 and its counterpart from 1937 and 1938, was comparatively mild, but it developed many situations resulting in bankruptcy and reorganization. Many solvent concerns were much embarrassed because they had contracted large amounts of bank debt During the War period and post-War period, when merchandise of all kinds was scarce, in fact in many lines almost unobtainable, the manufacturer or merchant was in continual fear of running out of merchandise, and he borrowed heavily to carry stocks of raw materials and inventory The banks went to extremes in making these loans and at the peak the margin of security in the Federal Reserve Banks above the 40 per cent of deposit deadline, was only 47 per cent. So far had the Federal Reserve System expanded credit in order to finance the inventory requirements of American industry, that when the decline in prices started in 1920, it quickly reached panic proportions The banks, under the pressure of the Federal Reserve Board, called upon borrowers to reduce their loans and forced a nation-wide liquidation which reached into every borrowing industry and which was especially severe in agriculture. Many corporations at this time were forced by the banks to place bond issues, secured by mort-

gages on their plants and property at 7 and 8 per cent interest in order to reduce, or liquidate these loans. As closely as can be determined, and there has never been any comprehensive research in the matter, the aversion to and distrust of large borrowing dates from this period Many business men who were either themselves embarrassed by the necessity of forced financing, or who were hurt by the embarrassment of others, from this time on distrusted bank borrowing as a means of short-term financing Assisted by the strong and active security market of the middle and late twenties, many large companies sold securities for the purpose of building up large working capital

Excluding bank borrowing, the second method of managing working capital is all that is left, namely, to provide a sufficient amount of cash to make bank borrowing, or any other form of borrowing, unnecessary These funds can be provided either by the sale of securities, preferably preferred and common stocks, since long-term debt is only a small degree better than short-term debt, or by reservations out of profits. It is this latter method which has been adopted by the most profitable industrial corporations The current resources of many large corporations are sufficient not only to finance current operations, but capital operations as well. The fixed capital requirements of the steel industry, the chemical industry, the paper industry, among others, during recent years have been financed primarily by drawing upon cash resources without placing any securities in the public investment market.

CHAPTER 27

PROVISION FOR LOSSES IN PROPERTY VALUES

The management of depreciation is an important financial policy Here we are dealing with a matter in which the management has discretionary power Because of this discretionary power, the stated income or profit available for dividend distribution to the stockholders may be enlarged or reduced

Well-managed business corporations make regular provision out of income to restore impairment in the value of their physical assets This impairment in serviceability value is known as depreciation. The life of every tool, building, machine, or structure is limited. No matter how carefully a machine may be repaired, no matter how attentive the equipment department may be to painting cars and rewinding armatures, the time finally comes when the machine, car, locomotive or building is no longer fit for use. Every piece of productive property, like every human being, has a period when repairs are at a minimum and work at a maximum, and a period of old age, finally ending in dissolution This period of useful service, in a machine as in an individual, may be lengthened by proper care. If the individual does not observe the laws of health, works under unsanitary conditions, or is subjected to excessive strain in his work, his working life is shortened.

It has been a criticism of the automobile industry that, by forcing the men on the assembly line to excessive speed, it wears them out at a comparatively early age, replacing them after they are no longer of service, by younger men This fact is often advanced to explain in part the policy of industries which operate to an increasing extent with high-speed automatic machinery, to employ young men and discard workers of forty or forty-five In the same way, unless a machine is repaired when out of order, sheltered from the weather when not in use, and protected from undue strain, its active life is lessened. True depreciation is the exhaustion of the serviceability of a machine or structure by use, weather, fatigue, or obsolescence, despite expenditures of money for normal maintenance.

Illustration of Depreciation

Allusion has been made to the increasing rapidity of technical change resulting from the dynamic character of our industrial society, and to the cumulative effects of such rapid changes upon mechanical developments Each improvement furnishes a foundation for future improvements In the developments of tools, machines, and processes, a wider field is drawn upon for the materials for each successive advance For example, about 1906, the first automatic cigarette-making and packaging machine was perfected. It had a capacity of approximately 600 cigarettes per minute. The large cigarette manufacturers hastened to install this latest improvement in the art of cigarette-making Within twenty-five years, a new automatic cigarette-making machine was placed upon the market with an average production of 1,600 cigarettes per minute, the increased speed of production being due to the discovery by metallurgists of a new alloy for use in certain of the bearings or working parts of the machine This alloy was the result of studies in the non-ferrous industry concerning the effects of blending various elements in the manufacture of alloy steel The result of this improvement made the original cigarette-making machines obsolete. The large manufacturers were forced by competition to replace the older by the newer device, long before the service life of the older device was ended

Until 1926, tin plate was rolled in a hot mill where, starting with red-hot metal, the ingots were passed back and forth through the rolls until they were reduced to the proper thickness This was a slow and costly procedure In 1926, the American Rolling Mill Company installed the first continuous sheet and wide strip-mill in the United States This almost eliminated labor in the process, it handled the material cold, and it had the enormous capacity of 432,000 tons a year. The sheets are passed through the mill at a speed of 20 miles per hour. Within eleven years, twenty-six additional continuous cold rolling mills had been installed with an annual capacity of 13,119,000 tons. The old-style mills were made progressively obsolete The relatively low cost of operation threw most of the business during the depression to the companies which had been equipped with the new machinery In 1936, lower prices were named on cold-rolled sheets By the end of the period, most of the important steel producers had invested large sums in the new equipment

Obsolescence also relates to processes. Twenty years ago all the wood alcohol, as its name implies, was produced by the distillation of hard wood. This industry has disappeared All of the denatured alcohol is now produced by distillation from coal-tar. Before 1920, gasoline was produced by heating crude oil at atmospheric pressure Beginning at that time the cracking process was introduced, which added higher pressures and temperatures to the distillation process, and enabled the recovery of 60 per cent of the crude in the form of gasoline, instead of 35 to 40 per cent by the old cooking process Within the last five years, the refining industry has discovered a method of producing gasoline from waste refinery gases at a very low cost, utilizing a by-product, much of which was formerly thrown away It is claimed that, when this process is fully developed, an amount of gasoline equal to 50 per cent of the present supply, can be recovered from waste gases.

Finally, obsolescence may result from a change in the demands of the consumer for the goods or services produced by companies in a particular industry. The situation applying in the case of the Lehigh Portland Cement Company, is an excellent illustration

Prior to the depression, during the period of peak earnings, the company owned and operated 20 cement plants of varying capacities, some of which had been constructed during the early days of the company's development. With 20 plants in operation, having a combined capacity of 24,000,000 barrels, the maximum quantity of cement the company shipped in any one year was 18,500,000 barrels As cement shipments began to gradually fall off in 1929 and more precipitously thereafter, it became necessary to shut down one plant after another. In certain sections of the country, where the company owned more than one plant at the same location, it naturally was far more economical to concentrate production on the fewest possible mills rather than to attempt to run all units at ridiculously low rates of operation The plants first to be closed were the oldest units located at points where the company had under existing conditions excess capacity

Because the present and future possibilities of the market made it evident that certain units could never again be operated, four plants were definitely abandoned and dismantled during the early days of the depression and were written off the books through charges against depreciation reserve in 1931 Of the remaining 16 mills, the net plant account of one more unit, which had not been operated since 1928, was charged against surplus in 1933.[1]

[1] *Commercial and Financial Chronicle,* Feb 29, 1936, p 1474

No industry is exempt from the corrosive influence of obsolescence The pace of invention and improvement is increasing Each discovery forms a foundation for others The automobile has destroyed the inter-urban trolley and reduced the passenger business of the steam roads Silk replaces wool Rayon replaces silk and cotton. Alcohol from coal-tar replaces wood alcohol Synthetic nitrate drives out the Chilean product Synthetic rubber threatens natural rubber Welding replaces riveting in structural steel work Electric refrigeration replaces ice Illustrations could be multiplied without number Obsolescence is a universal phenomenon No industry is immune from its threat

Depreciation from Obsolescence

Depreciation from obsolescence is prominent during the early stages of an industry, when improvement is especially active. The large-scale manufacture of television sets and plastics are new industries, in which improvement is very active. On the other hand, in long-established industries, such as flour-milling, canning, iron-smelting, and in most branches of the textile industry, the opportunities for introducing labor-saving devices are more limited, and the danger of depreciation from plant obsolescence, although not from demand obsolescence, is less The main factor influencing a concern to replace machinery, is competition A leading manufacturer in the trade may introduce a new machine by which he is able to reduce costs, and lower prices His competitors are forced to follow him The general substitution of synthetic alcohol made from tar or refinery gases, for wood alcohol, is a recent illustration. On the other hand, if there is no competition, as when monopoly conditions prevail, the old machines are used as long as they are serviceable, and only when worn-out are they replaced by improved devices The effect of automobile competition in improving electric railway equipment is well known. Electric power generation is subject to no such competition, and a large amount of obsolete generating equipment is still, because of the public service monopoly, in operation.

Depreciation resulting from business obsolescence, as distinct from depreciation due to wear and tear is a serious danger Conservative financial management demands that adequate provision be made to guard against losses of value from this cause.

Necessity of Providing for Depreciation

Understanding now the regular and inevitable, as well as the accidental and occasional reductions in the value of a company's property, we see the necessity of providing for its replacement In so far as these losses can be estimated, accurate provision can be made Contingent and extraordinary losses, however, can only be anticipated by providing such sums as experience shows will be sufficient to offset these items There remain the losses due to such causes as changes in fashion, the introduction of competing products, tariff or railway rate changes, or new inventions, against which no foresight can provide exactly on any known rate of depreciation, because there is no method of predetermining the amount of the damage.

The losses due to depreciation, if provision is not made to apportion them over a series of years, may suddenly accumulate and cause serious damage When a plant is new, repairs are light and replacements are not necessary This condition may persist for several years The management, not seeing the necessity for making provision against the day when their plant will be worn-out, may have paid out most of their earnings to their stockholders At the end of the fifth or sixth year, extensive renewals become necessary, machines are worn-out or become obsolete, and a reconstruction, a rearrangement, or a relocation of the plant may be necessary. If money is not available for these purposes, all that the management can do is to issue stock, notes, or bonds and spend the proceeds, not in increasing the value of their property, but merely in maintaining it at its original figure

An illustration on a small scale will serve A man obtained a pumping contract from a railroad The contract ran for ten years and called for a payment of $2,000 a year. The cost of the pump and other machinery was $5,000, and the operating expenses $1,000 each year The owner gave but nominal supervision to the plant, which indeed was all that it required, and estimated his profits at $1,000 a year or $10,000 during the life of the contract At the end of the time, however, when the contract came to be renewed, it was found that the pump was worn-out, the $5,000 invested had been lost, and it was necessary for the contractor to raise another $5,000 for the purchase of new apparatus. Instead of a profit of $10,000 during the ten years, the actual profits of the business were only $5,000. A correct accounting system would have required the

setting aside of $5,000 in such a form as to be available at the end of ten years for the purchase of a new pump

Method of Providing for Depreciation

Depreciation is provided for by building up in the assets of a business an amount of value equal to that which has been consumed or lost The amount estimated to be necessary for a given period, a year, is charged against the receipts as a part of the costs of production Provided the goods or services are sold by the business at prices above their cost, and payment is received, the amount of depreciation is recovered. This amount is retained by the business, being held either as a bank deposit, invested in securities, or spent upon new buildings or new machinery, and appears as an asset item. At the time of making the depreciation charge, the company is made accountable for the amount, by setting up, with a credit balance, a reserve for depreciation account This plan is followed year after year, until a reserve for depreciation of large amount is built up as a liability of the business, balanced by various assets which represent a certain amount of the receipts of the company In some form these assets are held in anticipation of the time when the depreciated assets will have to be replaced or reproduced.

Origin of Replacement Reserves

Reserves for depreciation and other contingencies have their origin in appropriations to take care of contingencies of irregular recurrence. From these annual appropriations, if the amount is large enough, current replacements are made, and the balance, if any, is carried to the credit of the reserve account. This amount is continually shifting, rising as appropriations are credited to it, and declining as charges are made for renewals, but tending usually to advance.

Now suppose that, after a term of years, since replacement is not usually necessary in the early stages of the operations of a company, new equipment is necessary to replace that which is unfit for service, or that a complete overhauling, a relocation, or a reconstruction of the plant is necessary, including a general replacement of its equipment with machinery of improved design The cost of reconstruction or replacement is provided either out of the cash which the company has in hand, or out of the proceeds of security sales. In case provision is made out of cash on hand, cash is credited and the plant account is debited for the total

cost of replacing the depreciated property. The plant account is then credited, and reserve for depreciation account is debited for the book value of the plant which is being replaced If the replaced plant is sold, cash is debited for the proceeds and plant account is credited Plant account is then debited and reserve for depreciation account is credited If the expenditure needed to make the replacement is too large to be thrown upon the receipts of a single year, provision for the outlay is made in the following manner. The company presents the following balance sheet

Assets		Liabilities	
Plant and Equipment	$2,000,000	Stocks	$1,000,000
Cash and Current Assets	500,000	Bonds	500,000
		Depreciation Reserve	500,000
		Surplus	500,000
	$2,500,000		$2,500,000

Suppose that $500,000 is required for replacements and reconstruction, and that only $200,000 of this amount can be provided out of cash on hand. The company issues $300,000 of bonds, increasing its debt to $800,000 and raising its cash to $800,000. Having supplied itself with funds out of which to finance the replacement, the procedure and entries are as described above The proceeds of the bonds, together with the $200,000 taken from cash on hand, are spent in renewing the plant.

Disposition of Assets Offsetting Reserve Accounts

The amounts accumulated to take care of depreciation may be disposed of in two ways They may be considered as a fund of value, and kept in asset forms which are specifically set aside for the making of replacements when these become necessary They may be considered to be a part of the current assets of the business and immediately available for use in the conduct of its affairs In the latter case, the reservations are not earmarked for any particular purpose.

The United States Steel Corporation keeps its depreciation and other similar appropriations in a form readily available for use, invested in the current assets of its business as a part of its working capital. If the directors should conclude that a more definite separation of the assets representing these various items should be made, they could make a

special deposit of all the money, or invest it in securities which could be used for nothing else than to provide means for the replacement and renewals as required.

The usual method of handling appropriations for depreciation is to mingle them with the general assets of the company where they can be put to the most advantageous use, either in increasing the bank balances of the company or its stocks of materials, or in paying its debts, or in additions and improvements to its plant. The method of keeping the amounts reserved in specific funds separate from the general assets of the business, must be approved. An amount of assets is built up to provide against some financial loss When the loss occurs, an immediate outlay of money is necessary If the accumulation is balanced by a fund held in cash or approved securities, the money is there, ready to hand If no fund is kept, financing, which usually means borrowing, will be necessary, and this may be difficult to arrange. The holding of large amounts of cash or approved securities available for contingencies is the safer method

In most cases, the amount and control of the various sums reserved is at the disposal of the board of directors Sometimes, however, corporate mortgages contain a requirement that certain sums shall be set aside for maintenance and depreciation Unexpended balances in these accounts are not subject to the control of the directors, except to use them for the purposes stipulated in the mortgage.

Limitation on Reserves

There is, of course, a limit beyond which it is inadvisable for the management of a company to provide for the depreciation of its property This limit is reached when the amount accumulated is a figure which, in the judgment of the directors, is sufficient to protect the business against extraordinary accidents At this point, additions to reserves for depreciation may be discontinued It has been observed that some industrial plants can be operated successfully with their original equipment even though depreciation has accrued to approximately 100 per cent of the original cost of its property

Such operation is possible because the service life of particular units of property is subject to wide variation Furthermore the accrued depreciation on these units may vary from zero to 100 per cent, depending upon whether they have been recently acquired or are about to be retired. During the period of operation when few replacements need to be

made, an excess reserve will be accumulated against the plant as a whole This reserve will tend to reach a figure which will remain more or less constant, when the cost of replacements will be equal to the amount of depreciation

Distinction between Surplus and Depreciation Reserve

The statement is often heard that a depreciation reserve is only a bookkeeping item without significance It is claimed that there is no real distinction between the surplus appearing as a liability item on the balance sheet, and the depreciation and other reserves which also appear as liability items Taken together, they represent the total accumulations out of income which are held in the business for the benefit of the business. The only difference between the surplus and the depreciation reserve lies in the fact that the surplus is usually, although incorrectly, regarded as belonging to the stockholders, to be distributed to them from time to time, either in cash dividends, or by various adjustments of capitalization. The depreciation reserve, however, is regarded as representing something belonging to the business, which is to be withheld from the stockholders to make good any extraordinary replacements or renewals for which the current reservations from income for the purposes of depreciation are not sufficient In the Ford Motor Company, whose stock is entirely owned by the Ford family, there is no need to make a separation between surplus and depreciation reserve There are no outside stockholders, no absentee owners to clamor for dividends which should not be paid. All profits can be credited to surplus

Other Types of Reserves

The balance sheet may show reserves in addition to the depreciation reserve A reserve for bad debts may be kept to provide for losses in the collection of bills and accounts receivable A reserve may provide against losses arising out of decreases in the market prices of inventories A company may also carry its own insurance, and establish one or more insurance reserves, usually counterbalanced by a fund of cash or securities These reserves represent the unexpended balances of appropriations to these purposes The Federal Corporation Income Tax Law recognizes, as deductible items in computing taxable income, only depreciation, depletion, and insurance reserves Other reserves may be established at the discretion of the directors, but the amounts credited to them are not deductible

from income liable to normal tax rate Illustrations of such reserves are bond discount reserve, tax reserve, special reserve for purchase of additions to plant, dividend reserve, and reserve for fluctuations in foreign exchange.

Computing Rates of Depreciation

The first step in providing for physical depreciation is the determination of the amount necessary It is the practice to use the original cost figure as the basis for depreciation calculations. The amount necessary to provide for depreciation is not set aside at one time, but instead is accumulated over a period of time. This fact makes it necessary to compute depreciation on a percentage basis. The percentage is obtained by estimating, sometimes in great detail, the active life of the different kinds of property, and dividing 100 by the number of years of estimated life, to obtain the annual rate of depreciation. By the method ordinarily followed, no account is taken of compound interest If it is estimated that an item of property will have a life of 20 years, 5 per cent of its original cost is reserved out of income in each year

A schedule that might be used for a street-railway company is as follows.

	Life, Years	Rate, Per Cent
Track, ties, bonding, etc	12 85	7 75
Paving and grading		
Granite block	16	6 6
Cobblestones	25	4
Electric equipment of cars	12–15	8 5 to 6 2/3
Iron poles	20	5
Power plant equipment	15	6 66
Shop tools and machinery	20	5
Building and improvements	50	2

These various percentages are applied to the costs of the equipment, and the results added together are assumed to give the annual requirement for depreciation for that year.

These rates, however, are subject to wide variations under different conditions C. I Sturgis has explained these variations in relation to railway equipment as follows

On a railroad, the life of ties varies with soil and climate, the life of bridges depends on the weight of locomotives running over them, the life of

locomotives depends on the quality of water and coal with which they are fed, and there is hardly a railroad tool or machine the life of which does not depend on local conditions, and even if, in determining depreciation, we could approximately estimate such variable factors as these, we would still have to consider what in the end will be the cost of the new articles to replace the old, and with markets ever fluctuating that is impossible definitely to determine Furthermore, prosperous roads, in maintaining high standards, consider equipment is worn out when, on poorer roads, it would be considered still good for many years of service

While admitting the influence of local conditions, such as climate, upon assumed rates of depreciation, it is possible to give proper weight to these influences on the basis of experience, and to ascertain, with a fair degree of accuracy, the life of the company's property It is also possible to ascertain, as we have explained in our discussion of maintenance, the effect of high and low standards of maintenance on depreciation Property which is well maintained will last much longer, and give more effective service, than where maintenance is neglected We may conclude, therefore, that depreciation due to wear and tear and to natural decay, can be closely approximated

Depreciation due to obsolescence and extraordinary accidents involving extensive expenditures upon the plant, can not be estimated A textile company imported an expensive machine from England and estimated that it would last five years. A depreciation rate of 20 per cent was established Within two years, however, this machine was displaced by a better one, so that the correct rate should have been 50 per cent Other illustrations are the passage of city ordinances requiring large expenditures on track elevation or electrification to abolish the smoke nuisance Such changes can not be foreseen The only thing to do is to make the reserves as large as practical, in the hope that they will be sufficient

Partial provision, it is true, may be made in the manner already indicated, by establishing various rates of depreciation, and setting up reserves against various contingencies The assets balancing these reserves are available for emergencies But even the most conservative management would find it difficult to make suitable provision out of its receipts, to protect it against every contingency which might arise For example, depreciation on telephone equipment may be figured at the rate of 10 per cent per annum This will provide for the replacement

of the plant at the end of ten years. But suppose the town is visited by a hurricane and most of the plant is destroyed This would be a contingency against which no foresight consistent with ordinary business practice would provide, particularly if the property were located in an area in which hurricanes were rare. To be sure, insurance against such losses might be available to the company, but even so, a portion of risk would have to be borne by the insured All that can be done in the event of such a catastrophe, is for the owners of the business to take their losses and build anew, increasing rates if need be, and if permission can be obtained from the proper authority, in order to recover over a period the money spent in rebuilding the plant.

Warding against Depreciation Due to Business Hazards

Business foresight will anticipate many of the necessary changes and losses of business by appropriating assets to meet these emergencies, through the medium of a reserve account. Where this is not done, money is spent in developing factors and conditions which will tend to overcome the changes and losses. This is exemplified by a statement concerning Du Pont in 1932.

> Company has adhered to its policy of maintaining large chemical and engineering research organizations This year approximately $1,600,000 was expended for chemical control of quality and yields of existing products, and in addition, approximately $5,400,000 was expended for the improvement of present processes and products and the development of new processes or products necessary to hold and improve company's position in the chemical industry.
>
> In support of the company's research accomplishments, it maintains a group of specialists, who give constant attention to procurement of patent protection for new processes and products, as impregnable as it is proper to obtain, and who guard against infringement of its patents, processes and trade-marks.
>
> The main purpose for which the depreciation reserves are created is to provide for obsolescence of permanent assets, which in the chemical industry is an important factor It is the practice of the company to carry all permanent assets at their original cost or a suitable appraisal value, and to charge current operations with maintenance, repairs and replacements due to wear and tear.
>
> The depreciation and obsolescence rates employed for the different industries and classes of property are established on the basis of experience, and revisions are made when warranted by additional experience. Buildings and

equipment are depreciated at rates ranging from 3% to 6% per annum in the older, well established line, and in the newer industries special equipment is depreciated at rates ranging from 7% to 20% per annum

It is essential to the safety of a business that large deductions should be made from profits for depreciation due to business hazards The depreciation rates allowed by the Internal Revenue Bureau do not provide for such emergencies The Bureau, it is true, in its schedules of depreciation allows for obsolescence of equipment, and its allowances are not unfair It makes no allowance, however, for reserves against business hazards and these are numerous Reserves for depreciation of foreign currencies, strikes, sudden changes in style, the effects of war upon foreign markets or materials supply, these and many other hazards are met with Reserves against these hazards are legitimate operating charges, and should be allowed for as a regular deduction from taxable income. Companies do accumulate reserves and resources against these contingencies When they occur, losses are taken and taxable income is reduced It would be better, both from the standpoint of the taxpaying corporation and the government, if the effect of these extraordinary losses were spread out over an extended period

As an offset to this sort of depreciation, several accountants and engineers have urged the natural appreciation in the value of the property, due to the development of its business

It was claimed by Frederick Delano that

the depreciation due to the diminished value of equipment, track, bridges, structures of all kinds, shops and shop tools is limited and is, furthermore, more than counterbalanced by the appreciation due to the fact that the railroad has an established business which amounts to more in the case of a railroad than does "good will" in the case of a mercantile corporation Industries, mines, and factories are established along its lines with switches and side-track facilities, towns grow up, and a certain amount of business becomes assured which requires time, money and energy to develop—all of which is charged into current operating expenses, and should be considered as an offset to any depreciation of the property

Besides the appreciation due to these causes there is also physical enhancement of value due to the solidification of the road bed and embankments, the establishment of water-courses and the replacement of the original structures with others of a more permanent character, without any addition to capital account, thus, wooden trestles, bridges, culverts, etc , have been filled with earth or replaced by steel or iron, stone or concrete

> No estimate can be made, moreover, of the enhanced value of the right of way and terminals due to the growing values of land, even though the existence of the railroad may have contributed largely to the development of the country through which it runs The railroad corporation suffers from this increased value if it is compelled to purchase any property as well as in the increase in its taxes, but it has not been usual to make any allowance for this Railway men generally believe that the appreciation of the property above described more than balances the depreciation, especially when it is remembered that the total physical depreciation under proper maintenance rules is limited to half the first cost of the property

The considerations advanced by Mr Delano should be kept in mind It is unsafe, however, to go as far as he does in claiming that appreciation offsets depreciation This increase in the value of a business is dependent upon earnings. Certainly, from 1930 to 1938, there was no appreciation in the value of railway property in the United States. At this time a large amount of railway mileage was in the hands of receivers, and railway earnings were greatly depressed. Railway property with 1.23 per cent earned on its appraised value in 1938, was worth much less than its stated book value.

There is only one safe rule to follow in the determination of questions of this character—to take the side of conservatism in the disbursement of earnings. As between deducting too much for depreciation and taking too little, the first course is usually to be preferred Excessive depreciation means that money which would otherwise be available for dividends is retained in the business, covered up and concealed from the clutching hands of stockholders, but eventually appearing on the right side of the income account. No one can be injured by conservatism in these matters. The hazards of business are so great that any doubt as to the propriety of such deductions is always to be resolved in favor of the conservative course.

Secret Reserves

Many companies, especially financial institutions, go even further and accumulate hidden reserves to guard against business hazards. This is usually done by marking down assets, such as patents, below their real value, or carrying other assets such as real estate or securities, at cost, making no allowance for appreciation A condition of this kind was revealed a few years ago by a group opposing the contemplated

consolidation of the Standard Oil Companies of New Jersey and California It was stated that

> the Kettleman Hills properties of Standard Oil Company of California are carried on the books of that company at $7 00 per acre The company owns one-half of the acreage in the North Dome section of Kettleman Hills According to the company's published statements, more than 10,000 acres of this property is now proven territory Various values have been placed on these proven properties, but the lowest value we have heard thus far is $50,000 an acre This is admittedly a minimum figure, but at this minimum figure, the North Dome property is worth approximately $500,000,000 This single item represents $38 for each share of Standard Oil Co of California stock, an added value not otherwise reflected in balance sheet figures

The existence of secret reserves enables losses to be kept from public knowledge Sometimes their disclosure would have an unfortunate effect on public confidence As long as these secret reserves are kept in the business, no harm is done However, where they are suddenly sold at prices far in excess of their reported book value, and the proceeds of the sale distributed as a special dividend, the directors are apt to be criticized by those who sold the stock just before the sale is made.

Summary of Rules of Depreciation

In final summary of the rules of depreciation the following may be taken as conservative (1) charge to maintenance the cost of minor replacements, even if the cost of the property substituted for that worn-out or displaced by a better machine is greater than that originally purchased, (2) maintain depreciation rates based on standards established by engineers familiar with the business in which the corporation is engaged, and after making due allowance for special and local conditions, and (3) provide additional reserves for special classes of losses not covered by outside insurance

Junk Value in Relation to Depreciation

In complying with the first rule above mentioned, management finds a strong deterrent to liberal replacement in the small return obtained from the sale of old property As a rule this has little value Not only must the newly acquired property pay its own way, but it must carry the burden of the unconsumed value of the property it has displaced.

Sinking Funds and Depreciation Funds

A comparison may be made at this point between sinking funds and depreciation There is a superficial identity between these two classes of deductions from income The sinking fund, whether maintained against so-called "wasting" assets—that is, coal or ore—or against the plant of an electric railway, or the terminable franchise of a public service corporation, up to the percentage of the total cost of the company's assets which is represented by its bonds, and up to the percentage of the cost of the property which is represented by the sum of annual appropriations for the sinking fund, is sometimes regarded as the equivalent of a depreciation charge. If the cost of the entire property of a company is represented by its bonds, which sometimes happens, and if its life is twenty years, a sinking fund of 5 per cent on the bonds is the same as a depreciation of 5 per cent on the cost of the property. At the end of the twenty years, the plant is worn out, the bonds are paid, and the company is back where it started, with the addition of the good-will and prestige which it has accumulated It can then incur a new debt for the original amount, probably at a lower rate of interest, rebuild its plant, and maintain its surplus intact

However, from the standpoint of safety of bonds and preservation of the physical efficiency of the plant, the identification of the sinking fund with depreciation is unsound The sinking fund is maintained to reduce the debt, on the theory that business affairs are uncertain and, whether or not the asssets of the company are of the kind called "wasting," that debt should therefore be reduced On the other hand, a depreciation reserve is built up, and current renewals are made so that the plant may continue as a working unit, that the business may live and not die If the sinking fund were large enough to pay off the entire debt before the plant needed extensive renewals, then the bondholders might be safe, it is true, but the stockholders would suffer the loss of the money necessary to rebuild If the stockholders had received in dividends the amount which, at the end of the period, they were required to put into rebuilding, they might deceive themselves into thinking that they had suffered no loss In many cases, they would have difficulty in raising the money Bond payment by a sinking fund, and provision for plant renewal by a deduction from profits are dissimilar. The objects and methods are different If considerations of safety are to govern the

financial policy of a company, a sinking fund must be maintained to retire, or at any rate, largely reduce the debt, and liberal allowances for depreciation must be made to replace and renew the equipment and the plant [2]

Handling of Depreciation Charges

We have next to consider the financing of depreciation Shall the depreciation charges be annually deducted from income as are maintenance charges and sinking funds, or shall the directors be given a certain amount of liberty in concentrating these charges upon years of large earnings? The various public service commissions which have passed rules on the subject, and the Interstate Commerce Commission, have always inclined to the opinion that depreciation should be a fixed quantity to be deducted every year. The Wisconsin commission, for example, provides that

> Every electric railway shall carry a proper and adequate depreciation reserve to cover the full replacement of all tangible capital in service There shall be opened a depreciation account, to which shall be charged monthly, crediting the depreciation reserve, an amount equal to one-twelfth of the estimated annual depreciation of the tangible capital in service of the railway, or as near that amount as the finances of the property will permit

On the other hand, the view of this subject which formerly prevailed among operating officials was expressed by the late Frank R Ford, of Ford, Bacon and Davis, as follows

> The depreciation fund is essentially a financial problem, the solution of which is apparently by law left to the directors of the corporation as they are empowered to determine the amount of current income to be set aside for working capital and the amount of dividends to be declared It is questionable if utilities commissions can lawfully impose rules for the charging of depreciation in cases where the physical property is fairly maintained and securities properly issued. I believe that no hard and fast rule can be laid down for charging a fixed amount to such a fund month by month or year by year; the proper amount to be charged should be known, and if in lean years this amount is not laid aside, in prosperous years the deficiency should be made up It might even be necessary to use this fund for other purposes than renewal of physical property, due to business contingencies unforeseen.

[2] A S Dewing in his *Financial Policy of Corporations* has developed the above line of reasoning at some length and with convincing emphasis

Depreciation Charges in Relation to the Corporation Income Tax

Mr. Ford's idea, while it may be endorsed, solely from the standpoint of financial administration, must be considered obsolete in the light of income tax regulations. A tax on corporation profits makes it imperative that every lawful deduction should be made from the income of each year. The text of the law and its administration favor large deductions for depreciation, and, by implication, the building up of reserves, for depreciation. If a company tries to concentrate its depreciation appropriations into years of large earnings, in order to take credit in its tax statements for excess depreciation, it must convince revenue officials that its allowances in former years were not sufficient, and this may be difficult to do. It is far better to deduct the full amount allowed by law each year, and also to put as much as possible of these reserves into special funds immediately available for replacements. By holding replacement funds in liquid form, a company will not merely be able to make its renewals at the time when costs of construction are lowest, but if these funds are continually being expended, earnings will be increased by the substitution of superior devices which may cost no more than those which they displace. A salutary feature of the corporation income tax has been the encouragement which it offers to the building up and utilization of large reserves.

Do depreciation charges enter into cost of production? In the strictest interpretation of the term depreciation, it is an element of cost. Provision must be made for replacement of the worn-out plant before profits, the difference between cost and selling price, can be computed. If this is not done, profits are overstated to the extent of the deficiency in replacement charges. As a matter of expediency, however, it is unwise to add depreciation to so-called "prime" cost, that is, the out-of-pocket money spent to produce the commodity or service, but to consider it as an element of secondary cost, which includes such items as depreciation, insurance, taxes, and overhead expense.

The importance of this distinction between prime costs and secondary costs lies in the use of costs in fixing the selling prices. The rule is that, up to the capacity of the plant, any business will be taken which yields anything toward paying secondary cost. In fixing railroad rates, for example, up to the capacity of the railroad plant to move freight, any freight will be accepted which yields one-fourth cent per ton-mile over

the cost of receiving, moving, and delivering If the company based its freight rates on total cost, stone, sand, and gravel, and such low-priced commodities would not be moved, and the railroads would not make the very considerable revenues which they now receive from this freight By separating costs into "primary" and "secondary" and establishing the primary cost as a dead-line below which the price or rate can not be lowered, the business can safely accept orders at less than total cost, but greater than prime cost, and so make profits which would otherwise be lost In this sense, depreciation does not enter into cost of production

CHAPTER 28

DISTRIBUTION OF PROFITS IN DIVIDENDS

Corporations exist to produce dividends for their owners The profits belong to the corporation If the company is successfully managed, under conditions of ordinary good fortune, the stockholders will in time receive these profits directly or indirectly in the form of dividends A cash dividend is a payment of the profits of the company to its stockholders expressed in the form of a certain number of dollars or cents per share, or, in the case of par value stock, at a certain rate per cent

Conditions Preliminary to Declaration of Dividends

There are two steps in the process of distributing profits to stockholders The directors, by a formal resolution, declare that profits have been earned, after which, by another resolution, they "declare" a dividend. As a preliminary to the declaration of a dividend, the directors consider the following (1) the cash or liquid assets of the company from which the dividends must be taken, (2) the prospects of business for the early future, (3) the ability of the company to obtain any funds which may be necessary for new construction by the sale of new stock or bonds. A company may be prosperous, but, on account of the rapid growth in its business which has locked up its cash assets in the form of accounts receivable and materials, it may not be able to pay out any portion of these profits in dividends Payment of a dividend could be made only by selling stock or notes to obtain the money While this is sometimes done, it is to be avoided if possible Again, the business of the company at the time the matter of paying a dividend is considered, may be profitable, but the outlook for the future may be in doubt. When a revision of the tariff is in progress, for example, those companies whose earnings will be affected by any tariff changes are inclined to conserve their resources and prepare for a possible shrinkage in earnings Companies whose business is rapidly expanding require large amounts of money for new construction and working capital It may not be desirable to raise this money by increasing capital stock Any money

required must come out of profits The directors, under such conditions, would be cautious in paying dividends

Directors Control Declaration of Dividends

The declaration of dividends is optional with the directors They have authority to fix the amount of cash working capital Until they "declare" a dividend, there is no way in which the stockholders can secure any share of the profits The directors are the trustees for the corporation and so for its stockholders They are given power to dispose of the funds of the corporation. No matter how large are the profits of the company, there is usually no way short of a proven charge of bad faith, in which they can be compelled to declare a dividend. The stockholders can only participate in profits through the method provided by law Various attempts have been made to force a declaration of dividends, especially on preferred stock, on the ground that large profits have been earned, and that the stockholders were entitled to share in these profits. These attempts have been generally unsuccessful.[1] The stockholder can invoke the aid of the courts to prevent the diversion of the company's funds to unlawful objects, he can restrain the officers and directors from paying to themselves exorbitant salaries, and he can prevent any improper use of the company's profits As long, however, as the directors leave the company's profits in the treasury, and until they decide that a dividend shall be paid, the stockholder can obtain no share of these profits His only remedy, in case he is dissatisfied with the management of the company, is to elect new directors or sell his stock and withdraw When a dividend has been declared, however, it becomes an obligation of the company, enforceable like any other debt

Former dividend practice was based upon the desire of stock investors for stability of income as well as more stable market value for their hold-

[1] Of recent years the courts have grown more critical of large corporate surpluses The Ford Motor Company was forced to pay a dividend on the ground that its surplus was too large for its business and should be distributed Of course, the good faith of an abnormal accumulation can always be attacked, and it is difficult to rebut the charge Exploitation of minority stock by the withholding of dividends is now very difficult if stockholders are alert and persistent in the defense of their rights There is a statute, seldom invoked, which provides for a 25 per cent tax on assets not necessary for the business of the company and retained in surplus The undistributed profits tax, now repealed in fact, though retained "in principle," from 1935 to 1939, imposed a tax on undistributed profits

ings This preference of the investor for stable dividends made it necessary, if the corporation was to continuously sell bonds and stocks, as far as possible to pay dividends at a regular rate. Financing, both short and long term, was considered to be easier and cheaper than when dividend rates were changed with earnings available for dividend payments. To quote again from a former discussion of the subject

A stable rate of dividend with its resulting higher and more permanent value is also of great advantage to the company. Many corporations, especially those whose receipts are not evenly distributed throughout the year, have occasion to borrow money in anticipation of income to meet obligations which mature before that income is received. Wages, interest, and taxes must be paid, and supplies purchased often before the proceeds of sales are received In order that a corporation should retain a strong position with the banks, it is important that its stock should be maintained at a good figure A high and sustained value for the stock of a company is ordinarily taken by the bank as evidence of its high credit. Of course, if this value is merely a recent marking up of stock exchange quotations, it may not have much weight with the bank officers, but if it is a steadily maintained quotation, and represents what investors really regard as the value of the stock, the banker considers it good evidence of the financial standing of the company applying for a loan On the other hand, the fact that a stock sells at a low price is usually a warning to the banker to discriminate against the paper of the corporation issuing the stock, unless the notes are well secured by indorsement or collateral

A settled investment value for its securities, which can be obtained only by stabilizing its dividend rate, also benefits the corporation because it makes it possible to procure, on more favorable terms, money for improvements and extensions A prosperous company is a growing company, and is under frequent necessity of selling stock or bonds The prices obtained for the new securities will depend upon the prices of those already outstanding If the company issues bonds, a high value for the stock indicates that the interest on these bonds is amply secured by surplus earnings This fact is prominently featured in advertisements of the merits of new bond and preferred stock issues If, however, the stock is selling at a low figure, the investor knows that the company which proposes to increase its debt has little security to offer its creditors aside from the property which the proceeds of the new bonds are to purchase A low price for the stock indicates that the judgment of market observers is unfavorable to the company The investor properly regards the past achievements of the corporation as the best assurance of its future prosperity No matter how large the net earnings of a company may be at the time an increase of stock or bonds is made, the low market

value of this stock which may result from an irregular dividend policy would be a warning that these large earnings would not be permanent Under such circumstances, it might be difficult to obtain prices for these securities commensurate with their real value, based on earnings and assets

How was this ideal of stability of common stock dividend distribution to be attained? Three rules are given

1 To pay no dividends for a considerable period after the company begins operation
2. To manage the expense accounts of the company in such a way as to reduce the fluctuations in surplus profits to the minimum
3. To pay out, in any one year, only a portion of profits in dividends.

If a fixed rate of dividend distribution is the ideal, the percentage of profits to be "safely" paid in dividends should vary with the regularity of profits To reconcile the necessity for stable dividends with the fact of unstable profits, the directors must pay out only such a percentage of profits as will leave a margin over the dividend requirements, assuming profits to fall to the lowest point which, in all reasonable probability, will be reached Directors ascertain from experience what are likely to be the lowest earnings, under the most unfavorable circumstances, and then fix dividend rates well below that point In order to maintain a given dividend, a corporation should place its maximum dividend requirement below its minimum earnings. If the opposite policy is adopted, large dividends will be paid out of large profits, and small dividends out of small profits

In following this old rule of stability in dividends, the percentage of average profits which can safely be paid to stockholders should vary with the regularity of its profits A corporation, the difference between whose maximum and minimum profits over a period of years is 50 per cent, should pay out only half the proportion of annual earnings which can be safely distributed by another corporation whose earnings fluctuate on 25 per cent The foregoing outline of dividend policy has been followed with more or less fidelity by text writers in corporation finance. The fact of stability and its implications dominate the reasoning on the subject.

This theory must now be discarded The writers confess, regretfully, for it is a beautiful theory, that, like so many theories—the advantage of trading on the equity, for example—the theory of a stable dividend

no longer explains the facts The theory of a stable dividend was all right when it was first formulated, and for twenty years afterward. It corresponded to the practice until 1930 During the last ten years, it does not correspond to the facts of dividend disbursement

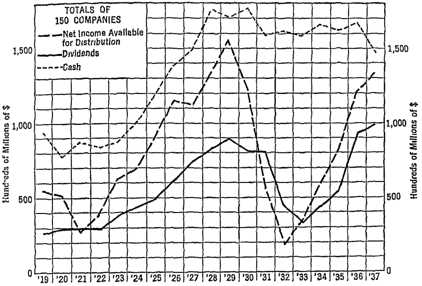
Well-managed and prosperous corporations, as a class, except in connection with permanent financing, have abandoned financing by bank loans. With this change, one part of the credit argument for dividend stability falls These companies have also reduced to small percentages of their long-term capital requirements, their sales of stock and bonds Even preferred stock dividends no longer represent the large percentage of earnings which they once did These companies do not depend, as they once did, upon the investor to furnish capital for expansion Outside the utility field—which means, for investment purposes, the light and power field; street railways, gas companies, and most of the railroads have ceased to expand, and do little financing—as will be shown in detail in a later chapter, corporations mainly rely upon their profits to finance their expansion They do not mainly depend, as they once did, upon the investment market These companies are no longer obliged to cater to the investor's preferences. Their need for and dependence on the investor's favor are no longer so great as before the World War. The investor prefers a regular rate of dividend He is disturbed and distressed by the sharp reductions which he encountered during the depression He would be glad if every corporation imitated the American Telephone and Telegraph Company and drew heavily upon its current assets to pay unearned dividends. But modern management cares for none of these things It closes its ears to the importunities of the investor and follows the course of action which, in its judgment will best conserve the earning power of the company, policies which, in the long run, contribute most to the welfare of the common stockholder. That policy is the preservation of the cash balance Like wisdom, cash is the principal thing, therefore, with all thy getting, keep enough of the proceeds in cash Only when sufficient cash resources have been gathered to provide for anticipated requirements, can the common stockholders look for dividends During periods of depression, when earnings decline, dividends are reduced and cash is maintained During periods of prosperity, dividends increase Dividend distribution is subordinated to the preservation of large cash balances.

A mass picture of the development of dividend policy from the first

World War is shown in the chart on page 385 prepared by a group in the graduate division of the Wharton School of Finance and Commerce under the supervision of David J Luck, now of the University of Texas. This chart shows for nineteen years, ending with 1937, the cash, net earnings available for dividends, and dividends paid, of 150 large industrial corporations. Until 1929, the rule of paying only a percentage of earnings was followed. The growth of earnings far outstripped the payment of dividends, although this consolidated statement shows that dividends were substantially and steadily increased Came the depression The blackness of night suddenly descended upon the American business scene Starting in 1930, earnings dropped to very low figures in 1932. Recovery began in 1933. By 1937, earnings had almost regained the levels of 1929. Had light and power companies been included in the computation, the showing would have been a little better. Had railroads been included, the showing would have been worse. These 150 companies included representatives of the groups of capital goods and consumers' capital goods industries. The demand for capital goods—steel, copper, machinery, electrical equipment—is highly irregular. These products are purchased for profit-making purposes When profits fall, the demand for capital goods falls also A number of consumers' goods companies are also included in this computation. The earnings of these companies, generally speaking, are more stable than the earnings of the capital goods industries. The chart gives, we believe, a reasonably accurate picture of the dividend policies of American corporations, compared with earnings available for dividends and compared with the cash balances out of which dividends are paid

An examination of this chart confirms the general statements with which this chapter opens During the depression of 1920-21, dividends remained stable, although earnings and cash sharply declined Money was available to pay dividends and they were, in fact, instead of reduced, slightly increased After this short depression, the trend of dividends was upward for eight years Earnings increased much more rapidly than dividends Very large sums were retained and invested by these companies. A large part of these sums so retained could have been safely paid in dividends As the period progressed, the percentage of earnings kept from stockholders increased In 1929, it was at the highest point

These companies were following a policy of safety The memories



of the post-War depression of 1920-22 were still fresh in mind, when even General Motors was hard-hit by the decline in earnings and the scarcity of cash. Especially significant in this connection were the large accumulations of cash, which reached $1,750,000,000 in 1929 Not only were large reserves accumulated, but they were liquid These reserves were available to maintain dividends, should earnings decline. Since they were included in large surpluses, stockholders, on the basis of accepted practice, might have expected that dividends would have been maintained at substantially higher figures than would have been warranted by current earnings.

The stage was set for another demonstration of the soundness of the accepted practice of dividend reserve (surplus) accumulation These vast sums of cash belonged to the stockholders. Now let the companies use them for their intended purpose. Let them draw upon the accumulations of good times to equalize dividend payments during the depression This, however, was done on a very restricted scale. Preferred dividends were generally paid, but common stockholders were compelled to await the revival of business Combined dividends fell from $900 millions in 1929 to $350 millions in 1932. This was $150 millions short of the amount available. Nineteen thirty-two was the only year when surplus was drawn upon to pay dividends. Meanwhile, cash balances were main-

tained. These were, in fact, slightly higher in 1932 than in 1931. These companies placed the permanent welfare of the business ahead of the desire of the stockholders for the continuation of his former rate of dividends.[2]

Significant, in the light of our present interest, is the movement of cash. During the depression, the consolidated cash balance was well maintained. It remained stable during the first four years of recovery, and was then reduced to take care of rising business activity.

Now came a modification of the surplus policy of 1922-29 inclusive. Earnings were large from 1933 to 1937, but instead of being retained in surplus, they were freely paid out to stockholders. These companies had, in the opinion of their managements, accumulated enough cash. Their working capitals were sufficient for their needs. Stockholders, the residuary claimants to distributed earnings now came into their own. Dividends rose from $350 millions in 1932 to $1350 millions in 1937. Out of $4.4 billions of income available for dividends, 26 per cent was retained and 74 per cent paid to stockholders. From 1922 to 1929, 43 per cent of the amount available for dividends was retained in surplus, and cash increased 100 per cent during the same period.

The dividend policy of American corporations has been changed. It no longer follows the lines laid down and followed in the past. The present policy may be summarized as follows:

[2] Of these 150 large industrials, the following either suspended dividends or reduced them to nominal amounts during the depression, although their cash was sufficient to have paid for one or more years at least half the dividend paid during the year preceding the year when dividends were passed. It must be remembered that the business sales of most of these had fallen to low figures, so that cash working capital requirements were reduced.

Allis Chalmers	Continental Oil
American Car and Foundry	Crane Company
Armstrong Cork	Champion Paper and Fibre
American Locomotive	Consolidated Oil
American Cyanamid	Caterpillar Tractor
American Rolling Mill	Glen Alden
Baldwin Locomotive Works	Gulf Oil
Brunswick Balke Collander	B. F. Goodrich
Briggs Manufacturing	Inland Steel
Bridgeport Brass	Kennecott Copper
Barber Asphalt	Kinney (G. R.)
Belding Heminway	Montgomery Ward
California Packing	United States Steel

1. Accumulate and retain sufficient cash to provide for the working capital and emergency needs of the company
2. After this is done, without regard to stability of rates, dividends may absorb a large share of current earnings.

Many companies, General Motors, General Electric and Du Pont among them, have carried this policy of *fluctuating* as compared with regular dividends, so far as to make large use of "extra dividends" and "interim" and year-end dividends

It is no longer possible to calculate the yield on common stocks of these companies by comparing the dividend rate with the price Instead, the stock quotations contain a supplementary note to the daily statement of sales and prices as follows

> Dividends, unless otherwise specified, are total paid or payable in 12 months to and including the payable date of the most recent dividend announcement

In most cases the statement of a "stated" or "regular" rate has been abandoned. Large use is made of the "extra," "interim," or "year-end" dividend. These descriptive phrases emphasize the provisional, temporary nature of present day dividend distribution. Du Pont's recent dividend record, for example, is as follows December 15, 1936, a year-end dividend of $2.00, March 15, 1937, an interim dividend of 75 cents; June 15, 1937, an interim of $2 00, September 15, 1937, an interim of $1 50, December 14, 1937, a year-end dividend of $2.00, March 15, 1938, an interim of 50 cents, June 14, 1938, an interim of 50 cents, September 14, 1938, an interim of 75 cents; December 14, 1938, a year-end dividend of $1 50, March 14, 1939, an interim of $1.25, June 14, 1939, an interim of $1 25 When the company has earned and received money which it does not need, the common stockholders receive a dividend There is, however, no moral guaranty of the amount. A sudden need for cash can be met by omitting one or more "interims" The stockholders can have no legitimate grievance, should this be done, since there has been no implied assurance of a regular rate.[8]

This policy of provisional dividends has been forced upon management in recent years by the rapid changes in the business picture. Many groups of long established companies, railroads, flour and baking, meat-

[8] Extra dividends have long been paid Until recent years, however, they were usually introductory to an advance in the permanent dividend rate.

packing, street railways, cotton, wool and silk textiles, cane-sugar refining, among others, have gone down in sales and profits and they have stayed down. They are declining industries. Their misfortunes are familiar to the companies which have not shared their fate. Other industrial groups, chemicals, light steel, electric light and power, alloys, rayon, non-alcoholic beverages, decentralized department stores, mail order, variety chains, for example, have improved their position. Even when "inter-industry" competition can be controlled, as in chemicals, competition *between* industries, *intra*-industry competition, is rampant. This commodity and service competition grows constantly more vicious and virulent. The mail-order companies have invaded the department store field. The radio reduces the profits of the motion-picture industries. Plastics threaten wood and steel as construction materials. Oil and natural gas gnaw at the demand for coal. Electricity supplants gas. Synthetic fibers, chemically produced, now threaten the demand for silk as a material for hosiery. Glass fabric is announced for curtains, rugs, upholstery, and even neckties. There is, in fact, no perceived limit to this competitive struggle.

The industrial world is a world of change. The pace of change constantly increases. No industry is immune from danger. Constant vigilance to anticipate the changes in demand—the substitution of new products for old—is required if corporations are to survive and prosper. Autobody companies develop bathroom fixtures, made by the same basic process. The Standard Oil Company of New Jersey has recently entered the production of a synthetic substitute for rubber, following in the footsteps of Du Pont. American Locomotive produces oil-refining equipment. Baldwin Locomotive Works expands the production of Diesel Engines, General Motors has developed the same line. Hudson Motors has entered the production of domestic washing machines. The heavy steel companies have in recent years shifted to light steel. Textile companies are using larger quantities of rayon yarn. Throughout the industrial structure, changes, supercessions, substitutions, follow each other in an endless procession. In such a world, the motto which guides progressive management is "Be ye also ready" and always ready. Readiness means cash. Cash can be borrowed. These new products, however, are experiments. Wise men do not borrow to make experiments. Cash on hand is a better source of venture funds.

We have, in this situation, a reasonable explanation of the change in

dividend policy. It is dominated by the necessity of preserving ample cash resources. To be safe, a company must not tie itself to any set rate of dividends It must be free at any time to direct earnings from dividends to capital expenditures. If a policy of too liberal dividends is followed before ample cash resources have been gathered, an unforeseen emergency, such as a sharp advance in raw material prices, may deplete working capital and force borrowing Some of the large cigarette manufacturing companies recently had this experience American, Reynolds, and Liggett and Myers, in 1937, borrowed $54,500,000 from banks to replenish working capital. These bank loans were the first incurred by these companies for many years. Their cash balances were large, but not large enough Their stockholders had received the funds which were needed to finance inventories Now the stockholders, acting through the companies, must repay some of the money paid out in dividends. No matter how stable are the earnings, and cigarette manufacturing earnings are among the most stable, before ample cash reserves are piled up, it is not safe to pay out practically all their earnings in dividends, as these companies did On the other hand, the old rule which regulated the permissible percentage of minimum dividends by the stability of earnings has been discarded General Electric, for example, from 1935 to 1938, out of $169.2 millions available for dividends on common stock, paid $152.6 millions—90 per cent, General Motors paid 88 per cent, during the same period Du Pont paid 83 per cent. These percentages, measured by former standards of industrial companies, are very high They are justified by the large cash balances which the companies carry, and by the control over the rate of dividend disbursements which, under the settled policies, these managements retain

CHAPTER 29

CORPORATE SURPLUS

Definition of Surplus

The surplus of a corporation is the excess of assets over the sum of all liabilities including capital stock, and reserves On the balance sheets of many large corporations, the surplus will be subdivided or classified The more common designations frequently noticed are Earned Surplus or Profit and Loss Surplus, Paid-in Surplus or Donated Surplus, and Capital Surplus Classification of surplus on the balance sheet according to its source is desirable because it avoids misinterpretation by security holders, and outside creditors, and shows the desire of management to present accurate information Surplus, of whatever designation, is significant to the shareholders It shows the extent of their equity in the corporation beyond the aggregate par value of their shares It affords a basis for determining the book value per share, an often used measure of share value The shareholder may be likened to a "residuary legatee." He is the last to gain from any increase in asset value, and the first to lose in the event of shrinkage. The rise and fall in the combined surplus accounts records the ebb and flow of his equity. It is the shareholder who participates in any distribution or reduction of surplus.

Sources of Corporate Surplus

Before considering the question of distribution or reduction of surplus, we examine the sources of surplus

A surplus may be derived from one or more of the following five sources

1. It may be contributed by the original subscribers to the shares. For example, when a bank is organized, in order to give an appearance of strength and thus inspire confidence, the share buyers may pay a price per share substantially in excess of the par or stated value per share, thus starting the bank on its career with a paid-in or donated surplus The amount of such surplus may be equal to the capital stock at

the beginning of business It may be increased from further share sales at a premium and from earnings It is the intent of management that such a paid-in surplus shall be retained by the bank, that it is part of the working assets of the bank, and will not be available for dividend distribution.

For other corporations, this source of surplus is not often utilized at the time the company is organized However, it often happens with corporations whose past operations have been prosperous and whose securities are selling on the market substantially above par, that new issues of bonds or stock will be taken at a premium Here is a paid-in surplus derived from the same source, the security holders themselves. Usually the entire proceeds of the new issue are put to corporate use, either for the purchase of fixed assets or for working capital No part of such a surplus can be available for dividend distribution If it is wisely used, and the corporation continues to thrive, profit from operation will increase, and a larger dividend disbursement may be made in the future

2. A second source of surplus is the sale of assets for more than their book value For example, a corporation may carry a part of its working capital in the form of marketable securities Such investments are usually listed by the company at cost Assuming that their aggregate cost was $1,000,000 and at subsequent sale the company realized $1,250,000, it would have a profit of $250,000 The same result might follow the sale of real estate, machinery and equipment, or patents. If the price received exceeds the depreciated or book value of such assets, a profit is in hand. Conservative management credits the profit to a special account sometimes called Capital Surplus. This prevents such gains from being looked upon by shareholders as a source of immediate cash dividends. On the other hand, it affords the corporation a means of absorbing possible losses, when assets must be sold at prices lower than their book value. An exception to this rule would be an investing corporation, sometimes called an investment trust, which *anticipates* profits from trading in securities, but even here conservatism would dictate the accumulation of a special surplus or reserve as a buffer to absorb future losses, before such profits would be immediately disbursed as dividends If capital gains of this character are reinvested in assets useful in the normal conduct of the business, future profits and cash dividends may be increased

3 A surplus may also arise from reappraisal of the physical assets of the corporation. Occasionally, in periods of advancing prices, when the

outlook for the future may be bright, and new financing is contemplated, particularly an increase in bonded debt, the company may have its physical assets appraised. At current prices, less depreciation to date, the valuation may be shown to be substantially above the book value of the assets at that time, such an advance will indicate a margin of mortgagable value sufficient to support an increase in bonded debt. This procedure is of course "window dressing." If the condition of the corporation will not warrant an increase in debt without reappraisal, sound practice can not accept the reappraised value of assets as justification for more bonds. Such increase in asset value should be credited to Capital Surplus or to an account whose title precisely describes its source, as "Surplus Arising from Revaluation of Assets."

A capital surplus may be produced when one corporation purchases the assets of another. For example, a new corporation may be created to take over the business of several other companies. If the new company issues a smaller par value of its securities in exchange for the assets than their aggregate previous book value, it may set up the difference as a surplus. This practice has been common in consolidations of public utility operating companies. The new corporation will not wish to write down the value of the newly acquired assets because its schedule of rates is based upon the fair value of the assets used in the service. This fair value may have been set by a Public Service Commission. This procedure may not be criticized so long as the source of the surplus is clearly indicated.

4. Within recent years, there have been frequent instances where surplus has been created by reducing the number of shares of stock outstanding or by reducing the par value per share, or by changing from par value to no par value with a smaller stated value per share than the previous par, or by switching from a higher stated value no par stock to a lower par value. These are methods of readjusting the capital account about which more will be said in a later chapter, but they must be mentioned in any discussion of the sources of surplus. If the management can not longer postpone the writing down of the value of certain assets, and if the shrinkage in value exceeds existing surplus, the shareholders' assistance in correcting this situation is frequently obtained. The corporation may be currently earning a profit from operation, but, so long as the capital of the company is impaired, will be prohibited by the corporation law of the state in which it is chartered (as in Delaware, for

example) from paying a dividend Impairment would exist the moment the reduction in asset value exceeded the previously existing surplus The shareholders are asked to accept or establish their loss in the book value of their stock at once, in exchange for a continuation or resumption of dividends A number of holding companies and management type investment corporations, which purchased their security holdings prior to 1930, have created surpluses in this way The shrinkage in market prices of the securities owned has proceeded so far from the high levels of 1928-29, when many of them were purchased, that the shareholders have been easily pursuaded to agree to the plan Again, such a surplus should be correctly labeled Even the title—Capital Surplus—might be misleading It is better to give it a title such as "Surplus Arising from Reduction in Par Value of Common Stock"

5 Finally, a surplus may arise as the result of successive accumulations of operating profits which were not currently distributed to stockholders Such a surplus may be held in the form of quick assets in a reserve or fund, or it may work its way into the assets, finding lodgment in fixed forms of various kinds, or it may become part of the working capital If a surplus is accumulated in the form of cash beyond the normal requirements of the business, it is in the least productive form for the corporation At the most, it will earn bank interest, which at present is very small It will be more productive if used as part of the general asset fund of the business A steadily growing cash balance may justify stockholders in clamoring for an increase in cash dividends and it will be difficult to argue them down if the management can not point to a rapidly expanding business. If the business is growing, it is common for these accumulated earnings to become bricks and mortar, machinery, inventory or receivables.

It is clear from the foregoing description of the sources of surplus that it is seldom a special deposit in a bank or a fund of securities held at the disposal of the shareholders [1] It is merely the sum by which the

[1] Among the surplus reserves frequently encountered is the "Reserve for Contingencies" If the contingency is imminent, or is likely to require action on short notice, the management may carry the equivalent of the reserve in a separate investment fund so listed among the assets It is for this reason that surplus reserves are not included in surplus per se as defined above Should the contingency reserve become extraordinarily large the shareholder would be justified in questioning its purpose In calculating book value per share the surplus reserves are usually included with other surplus items in the total equity

corporation's assets exceed its liabilities including capital stock. The following table shows the imposing size of the surpluses, together with cash and marketable securities of several of the larger well-known American corporations for the year 1937

Corporation	*Surplus*	*Cash and Marketable Securities*
Atchison	$380,435,793	$18,665,512 [2]
Great Northern	152,802,953	16,137,309 [2]
Pennsylvania	453,160,338	39,231,303 [2]
United States Steel	280,356,144 [3]	84,249,421
General Electric	121,456,521	47,536,253
Allied Chemical and Dye	181,878,253	68,863,230
General Motors	394,789,742	150,884,013

It is evident that the bulk of these surpluses were not distributable at the close of 1937 They were simply sums of value invested in the business, representing accumulations from one or more of the sources discussed above.

Elbert H Gary once described the surplus of the Steel Corporation with singular aptness and simplicity

> In this connection, there are many things to be considered which may be overlooked by a few They read of a surplus of, we will say, $490,000,000, or perhaps a little more, and assume that this is all cash, or assets quickly convertible into cash, like the surplus of a bank They seem to forget that only the smaller part is available cash, that the larger part is in inventories of raw materials like iron ore, coal, coke, stone, and other supplies, semi-finished and finished materials sold or unsold, unfinished buildings or other structures, receivables in course of collection, cash held in banks to meet maturing obligations, including purchases made but not delivered, such as cars, engines, ships, machinery, equipment of various kinds, etc , and, finally, that a large part, if not the larger part, of the surplus has been permanently invested in plants and properties.

Relation of Surplus to Dividend Rate

What now is the relation of this surplus appearing on the balance sheet to the rate of dividend? May it be drawn upon in case of emer-

[2] Cash only

[3] In 1935, United States Steel Corporation transferred $270,000,000 of "appropriated surplus to cover capital expenditures" to reserve for depreciation and depletion and amortization reserve

gency to make up a deficit in income? May it be distributed in large amounts as special dividends to stockholders?

Most surplus is merged in the assets not to be segregated or separately identified. It may, however, serve as a fund out of which deficits in the amount necessary to pay the regular dividend may be made up either by direct withdrawal or by borrowing. The surplus may also, from time to time, be directly distributed to stockholders, in a lump sum, as a special dividend. These various methods of utilizing the surplus we have now to examine.

Direct Distribution of Surplus

The surplus of a corporation may occasionally be used as a source of dividends to its stockholders, aside from its service in increasing the net earnings of the business, in the following ways

1. *Temporary Reduction of Working Capital* Due to a decline in business, the amount of cash in the company's treasury is increased as receivables are collected, the amount of new receivables falls off, and inventory purchases are reduced The company now has more cash than it needs. If the depression in business promises to be of long duration, the directors may decide to cheer up the stockholders with a special cash dividend. Here the corporation is using working capital for dividend payment when current earnings are insufficient.

2. *Distribution of Assets No Longer Needed.* Another method of distributing surplus directly to the stockholders is used when a company may have acquired in the course of its business certain assets which it no longer needs, such as coal-mining or express companies, or land companies The stocks representing these concerns may be held in the treasury of the parent company, and the dividends received on these stocks may be added to the other income of the parent company and merged into its general surplus available for distribution. In case it is expedient or convenient for the corporation to divest itself of the control of the properties, the stocks or bonds issued by the subsidiary companies may be distributed to the stockholders of the parent company as a special dividend

An illustration of this method is furnished by the distribution of the Great Northern Ore certificates to the stockholders of the Great Northern Railway Company. Certain iron-ore lands in Minnesota had been

acquired in the interest of the Great Northern Railway by James J. Hill, then its president, and his associates. These properties, aggregating about 60,000 acres, were located in the Missabe district of Minnesota They were controlled by the corporation known as the Lake Superior Company, Ltd., controlled by the Great Northern Railway The properties were transferred in the autumn of 1906 to James J. Hill, Louis W Hill, and E T Nichols, as trustees, and 1,500,000 shares of permanent beneficial interest in the trust were issued in December, 1906, to the Great Northern stockholders In August, 1906, a lease was executed to the Great Western Mining Company, guaranteed by the United States Steel Corporation, covering 39,295 acres of this land The Great Western Mining Company agreed to extract 750,000 tons of ore in 1907, with an increase of 750,000 tons annually, until a maximum annual extraction of 8,250,000 tons was reached in 1917 The lease fixed the net royalty for each ton of ore delivered at the dock by the Great Northern at 85 cents, and, after deducting 80 cents per ton as freight to the railroad company for transporting the ore, the balance was distributed to the holders of trust certificates at least once a year These certificates were immediately distributed by the trustees to the Great Northern stockholders as a special dividend.

It had long been the policy of the Great Northern to keep its dividend at 7 per cent Had these ore certificates been sold and the proceeds added to the regular dividends, this rate would have been exceeded. The lease protected the railway company in the transportation of the ore to be mined under the lease. It could, therefore, without danger of losing control of this traffic, distribute the certificates of beneficial interest in the lease as a special dividend to the stockholders. This was a direct distribution of its surplus by the Great Northern Railroad Company

The General Electric Company, in 1925, distributed to its stockholders the stock of its subsidiary, the Electric Bond and Share Company, a company organized to furnish business to the General Electric by promoting various forms of electrical enterprise where the construction, present and future could be secured to the General Electric These connections no longer being needed, the distribution was duly made and the surplus of the General Electric was reduced by the book value of the shares of the Electric Bond and Share Company

In 1933, General Electric Company and Westinghouse Electric and

Manufacturing Company, as a result of a court order, distributed substantial portions of their holdings of Radio Corporation of America stock to their shareholders as a special dividend, thus reducing their surplus by the aggregate book value of the R. C. A. shares so disposed of.

3. *The Dividend Reserve Fund* Third, a portion of the surplus may be put into a dividend reserve fund, withdrawn from the working capital of the business, and so invested that it can be drawn upon in times of deficiency of revenue to pay dividends. Unless the dividend reserve fund is so built up, the assets of the company can not be directly utilized to make up a deficiency in earnings without drawing down the working capital, as mentioned above, which may not always be desirable. A railroad company, for example, has invested its surplus in equipment, or in improvements to its line, or in securities of terminal or marine corporations whose operations are necessary to its business. It also carries a certain cash balance. It can not sell any of these properties or assets, or distribute its cash working capital without impairing its efficiency The investment of surplus funds in the business of the corporation merges and identifies them with the general assets of the company, which are used for its general corporate purposes, and which, unless the stockholders decide to wind up its affairs, pay its debts, and divide the balance, are not available for distribution. If, however, a company maintains a dividend reserve fund, it may use its surplus to make up deficiencies in revenue.

When a dividend reserve fund is established, amounts are withdrawn from the profits of the business, and invested in securities which are held as investments, and which do not represent the control of properties necessary to the company In a year of small profits, a portion of these securities can be sold, or they can be pledged as security for a loan, and the regular dividend can thus be paid. This plan is, in effect, the averaging of payments out of surplus over a period of years—the same principle as that followed by many companies in insuring their own plants where sums larger than anticipated fire losses are put into a fund out of which extraordinary losses are paid.

The American Telephone and Telegraph Company does not provide a dividend reserve fund, but it has accomplished the same result by carrying at all times a substantial asset item of "Temporary Cash Investments" On December 31, 1937, this account amounted to $103,-

218,109, principally United States Government obligations. American Telephone and Telegraph has maintained a $9 dividend for a number of years, one of those companies which still adheres to a stable dividend rate, although during the years 1932 to 1935, inclusive, it fell short by $204,843,238 of earning the dividends which were paid This deficiency each year was taken from unappropriated surplus which in turn was available because of the securities which could be converted into cash.

The dividend reserve fund as a means of financial stability can be endorsed without qualification although it is not generally adopted. The surplus of a company is properly considered as a portion of its capital, so are its various reserve funds. These are owned by the company They do not belong to the stockholders. A dividend reserve fund is, however, in a peculiar sense the property of the stockholders. It represents money which the directors could properly have paid them in past years, but which has been retained to make up occasional deficiencies in revenue below dividend requirements

The directors may well hesitate, and are, in fact, very reluctant to pay increased dividends out of surplus. They can, however, with a clear conscience, draw down the dividend reserve fund to make up shortages, since that is the purpose of establishing the fund When a dividend is passed or reduced, stockholders are dissatisfied. They are likely to demand that, with a large surplus, the rate should be maintained. When a dividend reserve fund is established, the stockholder knows just how much is available for him, and pays less attention to the surplus as his property, which the surplus is not. While dividend reserve funds are desirable, they are seldom set up. The new common dividend practice does not require them, and even in the days of "Stability" they were seldom met with. The A. T. and T. practice is exceptional

In concluding this discussion of direct distribution of surplus, it should be noted that, in each of the three methods, the assets of the corporation were reduced in amount equal to the reduction in surplus The corporation has divested itself of a portion of its asset value which has gone to the shareholders The surplus which measures the excess of asset value over liabilities including capital stock has recorded a like reduction.

Indirect Distribution of Surplus

With the exception of the three methods described—temporary reduction of working capital, distribution of assets for which the corporation has

no further use, and payment of dividends out of dividend reserve fund—direct distribution of the surplus is not possible The surplus is an indistinguishable part of the property of the company, merged into general assets. It increases in time, if the amounts carried to the credit of surplus have been wisely invested, the annual profits in which stockholders participate, but is not available as a fund for direct distribution in dividends The company can not properly sell any part of its plant to pay a dividend, or sell any stock held in order to control subsidiary corporations, or impair its necessary working capital, to make a distribution to stockholders The distribution of the surplus must usually be made, if at all, by increasing one or more liability accounts and reducing surplus correspondingly, rather than by reducing assets; by the indirect, rather than the direct method.

Stock Dividends and Reasons for Their Use

The usual method of distributing the surplus—although if we understand the surplus as consisting of assets, it is really not a distribution, but merely a reduction—is to declare a stock dividend The method of doing this, and the reason for doing it are both shown in the following resolution of the directors of the American Tobacco Company

WHEREAS, in the judgment of this board, it is to the interest of this Company to capitalize a substantial amount of its surplus so that it may permanently remain invested in the business, to accomplish which purpose the most convenient method is by the distribution of a stock dividend among its stockholders out of the authorized and unissued Common Stock "B" of the Company.

Therefore Be It Resolved (1) That there be and hereby is declared a stock dividend on the Common Stock and Common Stock "B" of this Company of 75%, payable in Common Stock "B" at par on August 1, to holders of record July 15.

(2) That on August 1 there be transferred from surplus to capital account an amount equal to 75% of the total par value of Common Stock and Common Stock "B" outstanding July 15, 1920, and certificates of Common Stock "B" equalling at par said 75% or warrants therefor, shall on August 1 be distributed pro rata among the holders of record July 15 of said Common Stock and Common Stock "B"

The business reason in most cases of stock dividends is, as in the foregoing illustration, the desire of the directors to retain profits in the

business. If they distribute a cash dividend and simultaneously offer their stockholders the right to buy an amount of stock equal to the dividend, it is not certain that all the stock will be taken Many stockholders may have other uses for the dividend than to invest it in new stock If, on the other hand, the directors hold their cash and distribute stock, they are in the same position as if *all* the stockholders under the first supposition had received their cash dividend and had endorsed the checks over to the corporation in payment for new stock. Some corporations, notably the North American Company, have made the stock dividend the regular dividend payment to common stockholders. The North American Company pursued this policy from 1923 to 1934, paying quarterly dividends on common stock only in common stock The chief reason for this method, as stated by the management, was to provide an automatic method of financing expansion of the business at reasonable cost to the company, and with a minimum of burden to the stockholder who could retain his new shares if he wished to add to his investment in the company, or sell them if he desired cash. In 1934 the company began paying common dividends, part in cash and part in stock, and since then has changed to all cash dividends

A stock dividend is sometimes described picturesquely, although incorrectly, as a forced loan from the stockholders. In this view, the surplus belongs to the stockholders, and the directors, instead of giving them a part of it in cash, give them a stock dividend This is not correct. Stockholders do not own the *assets* of the company They own the *company* They can only share in the assets when directors decide that it is safe to distribute them to the *company's* owners

Stock dividends are often declared to take up accumulations of preferred dividends These unpaid dividends are not, however, liabilities of the corporation, although it is customary in such cases, in order to clear the way for dividends on the common stock, that the preferred stockholders should surrender their claims to back dividends

Another reason for the payment of stock dividends is the bearing of the stock dividend upon the surtax on individual incomes Many corporations make enormous profits and these profits are frequently in liquid form, available for immediate distribution Before the imposition of heavy income taxes, large cash disbursements out of these profits would have been made These corporations, however, are for the most part controlled by rich men. To men in this position, the payment of a large

cash dividend, which is added to their taxable income, is looked upon as a calamity

Suppose, for example, that a man has $60,000 income derived from $500,000 of stock, paying 6 per cent dividends, plus a salary of $30,000. Under the provisions of the Revenue Act of 1938, in addition to the normal tax of $2,304 (4 per cent on the net income of $60,000, minus $1,000 Personal Exemption and earned income credit of $1,400), the stockholder pays a surtax of $10,610 Now, assume that the corporation has a large cash surplus which it desires to distribute Our stockholder's share will be $40,000, in addition to the $60,000 which he is now receiving, making his total income $100,000. On this amount his surtax will be $29,450 In other words, $18,840 of the $40,000 of the special dividend will be paid out in surtax

Now further suppose that instead of paying out $40,000 in cash to the stockholder, the corporation issues to him $40,000 of 6 per cent stock. His income is increased by only $2,400, the standard rate of return on $40,000, and his surtax is only increased to $11,450 In other words, by the first method he has only $21,160 to invest, which at 6 per cent will bring him in $1,269 90 per year, while from the return on his stock dividend he will receive $2,400, gaining $1,130 40 in annual income by substituting the stock dividend for the cash dividend.

Stock Dividends and the Federal Income Tax

The exclusion of stock dividends from incomes by the decision of the Supreme Court in the Macomber case in 1920 was rightly considered a most valuable concession to the men of large incomes, although, of course, no such consideration influenced the minds of the majority. The essential parts of this opinion follow [4]

On January 1, 1916, the Standard Oil Company of California, out of an authorized capital stock of $100,000,000, had shares of stock outstanding, par value $100 each, amounting in round figures to $50,000,000. In addition, it had surplus and undivided profits, amounting to about $45,000,000, of which about $20,000,000 had been earned prior to March 1, 1913. In January, 1916, the directors decided to issue shares sufficient for a stock dividend of 50 per cent of the stock, and to transfer from surplus account an amount equivalent to such issue

Myrtle Macomber, being the owner of 2,200 shares of the old stock,

[4] Eisner vs Macomber, No 318. Decided, March 8, 1920

received certificates for 1,100 additional shares, of which 18.07 per cent, or 198.77 shares par value $19,877, were treated as representing surplus earned between March 1, 1913, and January 1, 1916. She was forced to pay, under protest, a tax imposed under the Revenue Act of 1916, based upon a supposed income of $19,877 because of the new shares, and she brought action against the Collector to recover the tax In her complaint she contended that in imposing such a tax the Revenue Act of 1916 violated those sections of the Constitution of the United States requiring direct taxes to be apportioned according to population, and that the stock dividend was not income within the meaning of the Sixteenth Amendment. The Supreme Court decided against the Collector of Internal Revenue. The court said, in part:

Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through the sale or conversion of capital assets.

Can a stock dividend, considering its essential character, be brought within the definition? To answer this, regard must be had to the nature of a corporation and the stockholder's relation to it. We refer, of course, to a corporation such as the one in the case at bar, organized for profit, and having a capital stock divided into shares to which a nominal or part value is attributed.

Certainly the interest of the stockholder is a capital interest, and his certificates of stock are but the evidence of it They state the number of shares to which he is entitled and indicate their par value and how the stock may be transferred. They show that he or his assignors, immediate or remote, have contributed capital to the enterprise, that he is entitled to a corresponding interest proportionate to the whole, entitled to have the property and business of the company devoted during the corporate existence to attainment of the common objects, entitled to vote at stockholders' meetings, to receive dividends out of the corporation's profits if and when declared, and, in the event of liquidation, to receive a proportionate share of the net assets, if any, remaining after paying creditors Short of liquidation, or until dividend is declared, he has no right to withdraw any part of either capital or profits from the common enterprise, on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it to the interest of an owner, since the corporation has full title, legal and equitable, to the whole. The stockholder has the right to have the assets employed in the enterprise, with the incidental rights mentioned, but, as stockholder, he has no right to withdraw, only the right to persist, subject to the risks of the enterprise, and looking only to dividends for his

return. If he desires to dissociate himself from the company he can do so only by disposing of his stock .

In the present case, the corporation had surplus and undivided profits invested in plant, property, and business, required for the purposes of the corporation, amounting to about $45,000,000, in addition to outstanding capital stock of $50,000,000. In this the case is not extraordinary The profits of a corporation, as they appear upon the balance sheet at the end of the year, need not be in the form of money on hand in excess of what is required to meet current liabilities and finance current operations of the company. Often, especially in a growing business, only a part, sometimes a small part, of the year's profits is in property capable of division; the remainder having been absorbed in the acquisition of increased plant, equipment, stock in trade, or accounts receivable, or in decrease of outstanding liabilities. When only a part is available for dividends, the balance of the year's profits is carried to the credit of undivided profits, or surplus, or some other account having like significance. If thereafter the company finds itself in funds beyond current needs, it may declare dividends out of such surplus of undivided profits, otherwise it may go on for years conducting a successful business, but requiring more and more working capital because of the extension of its operations, and therefore unable to declare dividends approximating the amount of its profits Thus the surplus may increase until it equals or even exceeds the par value of the outstanding capital stock This may be adjusted upon the books in the mode adopted in the case at bar—by declaring a "stock dividend." This, however, is no more than a book adjustment, in essence not a dividend but rather the opposite, no part of the assets of the company is separated from the common fund, nothing distributed except paper certificates that evidence an antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company, but profits so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution In order to make the adjustment, a charge is made against surplus account with corresponding credit to capital stock account, equal to the proposed "dividend", the new stock is issued against this, and the certificates delivered to the existing stockholders in proportion to their previous holdings This, however, is merely bookkeeping that does not affect aggregate assets of the corporation or its outstanding liabilities, it affects only the form, not the essence, of the "liability" acknowledged by the corporation to its shareholders, and this through a readjustment of accounts on one side of the balance sheet only, increasing "capital stock" at the expense of "surplus", it does not alter the preexisting proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before The new certificates

simply increase the number of the shares, with consequent dilution of the value of each share.

A "stock dividend" shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution

The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit, on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment.

One of the results of this decision, rendered at a time when the need of our Federal government for additional revenue was especially heavy, was agitation in Congress for a tax upon undistributed corporate surplus It was felt by many people that corporations with large profits from operation during the War period had, by reinvesting them, so far reduced cash dividend disbursements that individuals of large income were unduly favored with respect to income taxes. This reinvestment accomplished two additional purposes. It enabled corporations to acquire quickly the assets for plant enlargement to meet growing demand for product without competing with the government and with themselves for the capital through security sales In addition, it kept the corporation tax lower, since this tax varied directly with the rate of return on invested capital. High corporate tax rates furnished a strong inducement to keep the investment large in order to reduce the amount of taxes From 1920 to 1926 there was an unprecedented volume of stock dividends declared by American corporations.

Agitation for a tax on surplus made small headway during the boom period ending in 1929, but came to the fore again during the depression Another strong argument for it was that persons of large income, as a result of the reinvestment of profits, were avoiding the higher surtaxes

The government, in every possible way, sought to increase the national income in the hope that increased spending of all kinds would stimulate the upward spiral of recovery and reduce unemployment. To attain these results, the Congress provided in the Revenue Act of 1936, for a tax on undistributed earned surplus starting with January 1, 1936. The tax ranged from 7 per cent to 27 per cent of the net income retained by the corporation. The corporation was permitted a credit from net income of the 15 per cent normal corporation income tax

Opposition to this tax by business men was strong. Their chief argument was that such a tax made no provision for the accumulation of reserves or surplus vital to competitive enterprise which is constantly faced with the dangers of obsolescence On the other hand, it endangered the security of the company, since earnings used for debt reduction or to offset drastic shrinkage in asset values were not exempt. Realization by Congress of the weakness of the principle resulted in a drastic change in the Revenue Act of 1938. The progressive taxes on undistributed profits were abandoned. The large corporation now pays 19 per cent tax on its net income, and if all income for the period is distributed in dividends it receives a credit of 2½ per cent.

The stock dividend as a device to reduce corporate surplus, was modified in 1936 by the decision of the United States Supreme Court in Koshland v Helvering [5] Here it was ruled that "where a stock dividend gives the stockholder an interest different from that which his holdings formerly represented he receives income" and therefore is liable for income tax thereon. Thus a stock dividend to a common stockholder in preferred stock or vice versa would be taxable income to the recipient, if the corporation had previously both classes of stock outstanding. If a stock dividend is paid in preferred shares to the common stockholder, and, before the dividend, only common shares were outstanding, the matter is questionable, although the United States Board of Tax Appeals has ruled that such a dividend would not be taxable to the recipient.

Stock Dividends and Split-Ups to Control Share Prices

Another reason for the use of the stock dividend deserves notice They have frequently been declared where profits have reached a sum which makes possible an advance in the dividend rate. A company may

[5] Koshland v Helvering, 298, U S 441, 56 S Ct 767

be earning 18 per cent after all charges and deductions before dividends, but only paying 6 per cent. An advance in dividends to 9 per cent would be safe and proper. Instead of advancing the rate, however, a 50 per cent stock dividend is declared and the dividend is maintained at 6 per cent The owner of 100 shares, par $100, who received $600 in annual dividends, now owns 150 shares on which $900 annual dividends is received. The dividend rate is the same, but the shareholder receives 9 per cent on his original investment The main purpose of this dividend is to keep down the market price of the shares, which would, on a 9 per cent dividend rise to undesirable heights and narrow the market for the shares. With a narrow or restricted demand, due to high price per share, there is greater danger of a sharp decline in price when shares must be sold quickly. The relative stability of price of moderate priced shares makes them better collateral for loans

Another device often used to reduce the market price of shares, which should not be confused with the stock dividend, is the stock split-up. Where the former increases the aggregate par or stated value of the capital stock and the number of shares outstanding through a debit to surplus, the latter increases the number of shares outstanding with no change in their aggregate par or stated value, and with no effect upon surplus. The stockholders merely agree to a reduction in par or stated value per share and a commensurate increase in number of shares, for the purpose of reducing market price per share There is no desire or intent to reduce the surplus. Each shareholder's proportionate interest remains the same, though his number of shares is greater. The stock split-up is recommended for this purpose when the market price of shares has advanced so far that corporate surplus, even if all of it were to be capitalized, would not permit sufficient new shares, to bring down the market price to the desired level.

Criticism of Stock Dividends

There is probably no phase of corporate finance, other than readjustment of the capital account and reorganization of insolvents, to which it is akin, that will confuse the student more unless he is thoroughly familiar with the accounting results and the market reactions thereto, than the stock dividend. The chief criticism of the large irregular stock dividend is the fact that it is often the forerunner of an increase in cash dividend rate as explained above, and thus lends itself to the use

of the informed insider at the expense of the investor and speculator. After the stock dividend has been paid, the market price often declines Many shareholders will sell a portion or all of their new shares unaware that the same dividend rate will be maintained. The insider buys at these prices, sure that the market will rise as soon as announcement is made that the former dividend rate will continue.

The periodic stock dividend, such as that used for years by the North American Company, is likewise open to criticism because its true nature is misunderstood by many people who speculate in stocks. In a period of rising stock prices, the market price per share may rise far above the amount of the surplus per share transferred to capital stock account. Whereas, on the books of the company, each new share may represent \$5 transferred from surplus, the market price per share may advance to \$50 Where no cash dividends are paid on this stock to serve as a check on market price, the uninformed buyer of such shares is hopelessly at sea This evil is further magnified and a new group of investors or speculators is affected where the shares of a corporation using the periodic stock dividend are owned by a holding company or an investment company There have been cases where the holding company reported as income the market value of the stock dividend instead of the book value of the transfer from surplus of the company declaring the dividend, and where the additional shares so received were not sold at the market but were retained.[6] Such practice can only hopelessly confuse large numbers of security holders who are uninformed with respect to such manipulation

[6] Graham and Dodd—*Security Analysis* (McGraw-Hill, 1934) Contains an interesting illustration of this practice, pp. 346-47.

CHAPTER 30

THE PROVISION OF NEW CAPITAL

In our study of the financing of the corporation, we have passed in review (1) its promotion, (2) the materials which can be used in making up its capital structure, (3) the principles which control the selection and arrangement of these materials in a plan of capitalization, (4) the more important financial problems of management We have next to examine the rules which regulate the growth and expansion of the business.

Biologists tell us that organisms never stand still for long, that they are always advancing or receding To stand still is the beginning of decay The same law of life controls the activities of business organisms, made up of human beings, and dealing with other human beings as competitors and customers. If a business is to live it must grow.

New Capital as a Protection against Competition

An influence which is effective in forcing a corporation into a policy of expansion is the necessity of guarding against the encroachment of competitors by occupying the territory in which these competitors would thrive If the demand for its products or services increases, the corporation must enlarge its facilities to supply the demand, if it does not, and competitors are permitted to occupy the new territory, there is danger that they may follow up this conquest by an approach to closer quarters.

An illustration of the reasons for providing additional capital funds is given in a circular letter of the president of the Central Union (Bell) Telephone Company to the stockholders, at the time when the Bell Company was embarking on its policy of expansion.

After two months' investigation I find it imperatively necessary that at least $3,000,000 be provided without delay The people of the states of Illinois, Indiana, Ohio and Iowa want telephone service Will you supply it, or must someone else? Are you doing it with fewer than 70,000 stations? No When you have 300,000 exchange stations, then you have a good start, not before. When you have 150,000 exchange stations, at proper rates, you

will have a plant upon which you can earn something with which to build up the second 150,000 With your present 70,000 stations, you cannot build up anything except opposition You are not satisfying the public, because your system does not reach far enough There are scores of villages and small towns, taken as a whole, that should have 50,000 telephones, and in which the company has not one single instrument What you want done must be done now Later on, and a very little later at that, will be too late.

An illustration of the truth of the observations contained in this circular came under the writer's observation in Hammonton, New Jersey, a town of about 4,000 people The Bell Telephone Company had possession of the field; there were only about twenty-five stations in the town, the instruments were antiquated, the service wretched, the rates high. Since the Bell Company showed no disposition to improve matters, the citizens of the town organized a company, raised $20,000 and installed an exchange, which in the first year served 300 subscribers and furnished a considerable amount of long-distance business to the competitor of the Bell Company. The Bell Company could easily have had these subscribers if it had shown proper enterprise. Many of these small companies have since been acquired by the Bell System, often at high prices.

Individuals and Partnerships Not Permanent Forms of Organization

In the days when business was organized around individuals, in partnerships, growth was limited to individual capacity, which is seldom transmitted to the next generation. Business life was short. When the founders died or retired, a reorganization or a sale was often necessary Business ability, a development of the acquisitive instinct, is an inheritable trait, but is usually overlaid in the second generation with manifestations of other instincts. It is "contaminated" by the parental bent seeking expression in works of charity and education, or by the self-regarding instinct which finds expression in costly display which may be seen of men, or in the harmless survivals of the predatory regime, horse- or boat-racing, mountain-climbing or big game-hunting, or in the pursuit of power in the political arena. Run over the names of the business giants of the last generation. The second generation of Rockefellers are occupied with conservation rather than expansion. Marshall Field left no descendant of comparable ability, nor did Jay Gould. The stream of Vanderbilt business genius, holding on for four generations, an extraordinary manifestation of the persistence of business ability, is no

longer visible. The younger Hills have not apparently inherited a full measure of their father's constructive genius Exceptions may be noted. The Morgan family is still hard at work Mr Harriman left descendants who promise well For the most part, however, rich men's sons do not emulate their fathers. If we relied upon the persistence of family ability to continue enterprises, most of the business enterprises of each generation would expire with the founders.

Permanence of the Large Corporation

Fortunately, the modern corporation, especially when it has reached substantial size, is independent of individuals Rules of procedure, established lines of business conduct based on long and successful experience, traditions of policy, grow up for the guidance of the officials These great organizations are like the trees of the primeval forest. They are wide and deep rooted in the desires and necessities of mankind, and in preferential opportunities to supply human wants. Their affiliations go into every line of human activity They have their spokesmen in the state legislatures and in the national Congress The leaders of the bar are among their counsel. Judges, both state and federal, are alert to protect their rights. They are allied with banks, insurance companies, mining companies. Public service commissions, as shown in the recent hearings in New York, because of the great importance of the utility companies to the communities they serve, and the great ability with which they are represented before these commissions, do not regard the large public service companies with any hostility—quite the contrary, in fact. Large corporations are able to equal in quality and price the best efforts of their competitors, and, in the words of the late Theodore P Shontz—"when price and quality are equal, then friendship begins" Their methods and machinery are standardized. They spend enormous sums on research and on patent protection. Their advertising appropriations run into many millions. The directing members of their personnel have competent understudies to take their places in the event of death or resignation. Their working funds are kept at such large figures that an ordinary depression does not disturb them. The great corporations now dominant in every line—transportation, mining, manufacture, commerce, merchandising—are, in the utmost permissible limit of that word in human affairs, immortal, independent of changes in membership and management.

Provision of Working Capital

New capital may also be required in the form of cash and cash assets as working funds to handle an increased amount of business If a company makes large additions to plant, or if the production of its plant shows a substantial growth, in case it does not make corresponding additions to its working capital, it is forced to become a heavy borrower. While this situation causes little inconvenience when rates of interest are low and money easily obtained, should a financial stringency occur, when loans can not be renewed, serious trouble may result Even under ordinary conditions, an inadequate working capital may result in heavy expense to the corporation A report of the president of the Pressed Steel Car Company contained the following.

Since the incorporation of the company the profits have aggregated $4,312,285. Out of these profits has been paid $2,625,000 in dividends The McKees Rocks plant cost $5,581,580, and additions and improvements to original plants amounting to $555,702, have been taken out of the initial working capital and earnings. From this it will be seen that the actual cash working capital has been encroached upon, but the plants and capacity have been more than doubled, and the monthly production increased from $1,000,000 to upward of $2,000,000, the full operation of the plants

It is necessary to carry between $4,000,000 and $5,000,000 worth of material on hand, and for this purpose the company has been compelled to be an extensive borrower. During the year it was thought prudent to fund this indebtedness. Therefore, a mortgage for $5,000,000 was made to secure five per cent notes maturing at the rate of $500,000 each year, with the right to anticipate payment of all or part. These notes have been disposed of on terms advantageous to the company By this means the company secures extra working capital, and its interest charges are limited not to exceed $250,000 the first year, and $25,000 less every year thereafter There was disbursed last year for interest on borrowed money $215,821, which was charged off to operating expenses, and we believe that more than the difference appearing between this amount and $250,000 can be saved in extra discounts on materials purchased

Profits Earned by Working Capital

The Pressed Steel Car Company, in funding its large floating debt, not only made the economies indicated in the president's statement, but also removed a danger of embarrassment which might have resulted

from failure to renew these loans. The receivership of the Westinghouse Electric and Manufacturing Company, in 1907, was due to inadequate working capital, and to the efforts of the company to supply this deficiency by contracting bank loans, and by piling up obligations to merchandise creditors Working capital is properly regarded, not merely as essential to the safety and prosperity of a company, but as perhaps the most profitable part of its equipment for business.

In recent years the large companies, which set the standard for business, have accumulated enormous cash resources. The immense volume of working capital, held in reserve for contingencies, has sought employment on the stock exchanges A recent compilation of the cash of fifty representative corporations showed a total of $1,200,000,000 We have seen that this development is seriously affecting the commercial loans of banks Large corporations no longer depend upon banks They are lenders, not borrowers. The banks must look to collateral loans, real estate loans, bond investments, and instalment loans to employ the funds intrusted to them If the movement toward self-financing, independent of banks, continues, a serious decline in the commercial banking business is to be anticipated

New Capital Required for Plant Reconstruction

New capital may be required for the reconstruction of a plant where a profitable business has been sacrificed because the physical condition of the property has been neglected A case in point is that of the Kansas City Southern Railway Company when taken over by the new management in 1905 Here was a road operating in a territory rich in traffic possibilities, and carrying a sufficient amount of traffic to pay its interest charges, in spite of its impaired physical condition It was estimated, to put the property in a suitable condition for handling present and prospective traffic, and to expand the business of the company to its proper size, that the expenditures listed on page 413 would be necessary

Most of these expenditures, since they were of the nature of replacements, should have been spread over a period of years, and charged to operating expenses, not to capital Over $5,000,000 of the amount which was deemed necessary to be spent on the property, represented deferred charges to maintenance and betterments The company should not, in a narrow view of the situation, have raised any capital by the sale of securities for the reconstruction of its plant, but should have devoted

Repairs and improvements to track	$2,983,856.00
Reinforcements and reconstruction of bridges	510,000.00
Repairs and improvements to equipment	540,000 00
New tracks	388,000 00
New freight depot facilities	125,000.00
New water stations	65,000 00
New shop facilities	435,000 00
New telegraph	34,000 00
New fencing	180,000.00
Work at Port Arthur, Texas	50,000.00
New equipment	1,604,749 50
TOTAL	$6,915,605 50

its surplus income to the purpose Under the conditions confronting the management, however, there was no surplus income. At the same time, the expenditure of this large amount of money, no matter how provided, would put the company in position to make large earnings. Said President Edson

Your officers are convinced that with the improvements and additions which have been set forth, which will require two or three years to complete, and which will enable the road to handle expeditiously and economically all traffic which may be offered, the gross earnings will show an increase of from twenty to twenty-five per cent over the gross earnings for the year ending June 30, 1905, and that, with the economies which the additional facilities will make possible, the ratio of operating expenses, including taxes, to gross earnings, will not exceed seventy per cent.

Taking as a basis the minimum of twenty per cent increase in gross earnings, the following results may be confidently expected under existing commercial conditions.

Gross earnings	$8,272,387.54
Operating expenses and taxes	5,790,671 28
Net earnings	$2,481,716 26
Interest on bonds owned	32,501 00
Total income	$2,514,217 26
Interest on bonds	900,000 00 [1]
Net annual surplus from income	$1,614,217.26

[1] Not all deductions are given

From which must be paid, of course, the interest on such funds as may be borrowed for improvement.

From this it seems certain that, unless overtaken by some unforeseen and general commercial disaster, the earning capacity of the property amply justified the capitalization of the amount necessary for improvements and extensions.

The surplus for the period to which this report refers was only $610,-191.80 This income was in danger of disappearing, owing to the inability of the company to handle the business offered The expenditure of approximately $7,000,000 would show earnings of 14.28 per cent on this amount The conclusion that the cost of rehabilitating the Kansas City Southern Railway Company should be defrayed out of new capital provided for the purpose, and charged to the various asset accounts, instead of being charged to operating expenses or depreciation, was evidently correct Acting upon this advice, the stockholders authorized an issue of $10,000,000 4½ per cent second mortgage bonds, pledging them as collateral for $5,100,000 negotiable gold notes. Most of the proceeds were spent in making good the omissions of the past, for the sake of obtaining the profits of the future.

Obsolescence and New Capital

Obsolescence presents a serious problem of capitalization. Suppose, for example, that a new locomotive is introduced which doubles the efficiency of the standard type. The railway has good credit. It can raise all the money necessary to replace its locomotives with the new type. Shall this be done? Suppose that a locomotive runs 50,000 miles a year at a cost of fuel per engine mile of $.90, or $45,000. The new type shows a fuel cost of $.45 per engine mile, or $22,500 The average cost of the locomotives on the road, less 5 per cent depreciation, is $25,000, and their average life expectancy is 10 years The company owns 800 locomotives fit for service To replace these with the new type will cost $32,000,000, less the problematical value of the old engines for sale in various out-of-the-way places The fixed charges on the new engines amount, including interest and depreciation, to $3,520,000 per year. The annual saving on 40,000,000 engine miles will be $18,000,-000 per year The loss from scrapping the old locomotives will be $20,000,000. Interest on this sum, plus a write-off of the loss over eight years will be $3,700,000 per year for eight years, or a total annual

fixed charge of $7,220,000, against which is a saving in fuel of $18,000,000, or $10,780,000 net profit on the replacement There can be no question, under the assumed conditions, that the scrapping of the old equipment is a wise move This is an extreme case, although one which is foreshadowed by recent developments in locomotive design and practice.

The larger the saving on the new appliance or process, the more immediate should be the substitution. Before these changes are made, exhaustive tests assure their practicability, but when that is once established, there should be no hesitancy in writing off the loss, and fully capitalizing these highly productive expenditures

Expanding and Declining Industries

Mere size is not enough to guarantee success. Increased production depends on increased demand. The growth of corporate capital depends on the ability of management to forecast demand trends. Many industries have not been able to make this forecast These industries are classed as *declining*. They do not expand their plants. The tendency is rather to reduce the scale of their operations On the basis of demand trends, the following industries may be classified as declining

Personal Accessories
Soft-Pile Fabrics
Sporting Goods
Furs
Bedroom and Kitchen Equipment
Cane-Sugar Refining
Dairy Products (excluding Borden and National)
Cuba Raw Sugar
Crackers and Biscuits
Baking and Flour
Meat- and Fish-Packing
Cigars
Snuff
Oil-Refining
Anthracite Coal
Publishing and Distributing
Men's Furnishings
Full-Fashioned Hosiery
Cotton, Woolen, and Silk Textiles
Shoe Manufacturing
Underwear (Men's)
Printing Materials and Equipment
Excavating Equipment
Petroleum and Natural-Gas Equipment
Railway Equipment
Chemicals, Solvents
Newsprint
Fertilizer
Leather
Iron Ore, Wrought, and Pig-Iron
Non-Ferrous Metals
Heavy Steel

Rubber and Rubber Tires
Bituminous Coal
Cast-Iron Pipe
Cement
Building and Construction Equipment
Truck, Bus, and Cab Manufacturing
Shipbuilding
Building Construction
Marine Transportation
Telegraph
Electricity, Gas, and Street Railroads
Bus and Cab Transportation
Metropolitan Electric Passenger Transportation
Food Chains
Coal and Ice Distribution
Restaurant Chains
Manufactured Gas
Motion-Pictures

Another group whose members operate in accordance with the trends of demand may be classed as expanding industries

Hard-Surfaced Floor Coverings
Consumers' Goods and Services Machinery
Automobile Manufacturing
Domestic Powered Accessories
Beet Sugar
Puerto Rico Sugar
Confectionery
Fruit and Vegetable Canning
Fresh Fruit
Packaged Foods
Refining of Corn Products
Cigarettes and Accessories
Drugs and Proprietary Compounds
Non-Alcoholic Beverages
Chewing Gum
Tobacco
Consumers' Paper Specialties
Photographic Supplies and Equipment
Soaps and Cleaning Compounds
Rayon
Refractories
Die-Casting
Machine-Tools
Moving Material Equipment
Steel Mill Equipment and Steel Products
Business Machines
Farm Machinery
Electrical Equipment
Multi-Industrial Machinery and Products
Chemicals (not otherwise stated)
Chemicals, Carbon Black
Vegetable Oils
Book and White Paper
Glass
Alloys and Raw Materials
Precious Metals
Light Steel
Ball and Roller Bearings
Automobile Accessories (not otherwise stated)
Internal Combustion Engines
Metallic and Cork Containers and Enclosures

Paper Board and Containers
Salt
Sulphur
Crude Oil
Paints
Synthetic Building Materials
Tank-Car Construction and Operation
Railroads (Coal and Iron Ore)
Telephone
Mail-Order
Electric Power and Light
Decentralized Non-Metropolitan Department Stores
Variety Chains
Metropolitan Department Stores
Shoe Chains
Drug Chains
Automobile Accessories (Chains)
Furniture Chains
Instalment Finance Companies
Personal Services

Many declining industries, railroads, surface electric railways, cane-sugar refining, marine transportation, coal, baking and flour, manufactured gas, motion-pictures, and meat-packing, operate with a large investment in specialized plant, which can not be turned to more profitable uses When demand declines, decline of profits quickly follows The business decays, sometimes rapidly, as with the street railways, sometimes slowly, as with the cracker and biscuit and cane-sugar refining industries There is nothing the managements of these declining companies can do. They have nowhere to go, even if they awaken in time to the necessity of shifting the processes and products. An official of a sugar-refining industry, when asked what his company could do to offset the downward movement of profits, replied, "We can do nothing but sit here till we dry up" Another company in this industry has closed one of its plants, and is operating another plant intermittently. Expansion in such a business is impossible.

Experience of Du Pont

Expansion of assets is confined to expanding industries, where as long as the demand rises, as in Diesel Engines, Automobiles, Electric Light and Power and Chemicals, plant investment will increase The more progressive managements do not wait for demand to leave them. They are constantly at work to discover and develop new products upon which they can build new sources of earnings.

One of the best illustrations of progressive expansion is furnished by Du Pont This company, originally devoted to the manufacture of explosives, began to diversify as early as 1904. During the War, the

policy of diversification was intensified. One branch of its activities was coal-tar dyes. Through internal expansion, and by the purchase of other companies, it became a leader in this field. It spent more than $40,000,000 before any profit was returned. This sum was spent for plant investment, operating deficits, and research It made heavy investments in synthetic nitrogen. The production of synthetic nitrates was followed by an extensive drop in nitrate prices; and synthetics set the pace. A wide extension in agricultural and industrial uses of nitrate followed the fall in prices. In 1923, Du Pont began the manufacture of a superior packaging and wrapping material—"Cellophane." The initial price was $2 65 a pound Nineteen price reductions brought the price down to 40 cents a pound The company has followed the trend of the market in the plastic industry In the early thirties the established nitrocellulose plastic was threatened by the competition of the acetate plastic. Du Pont, in meeting this problem, added the new acetate plastic to its other lines.

During the twenties a technological revolution was transforming the solvent and lacquer industry Lacquers are mainly sold to the automobile industry, in which Du Pont, through its ownership of General Motors stock, is interested Du Pont played a part in the development of a nitrocellulose lacquer, which reduced the time required for drying

Later the nitrocellulose lacquers encountered the competition of synthetic resins and varnishes. Du Pont, through its paint division, did not lag behind. It introduced a number of synthetic resins into the paint and lacquer market Because of its activities in so many of the process industries, Du Pont had become an important user of heavy chemicals not produced within its own organization. In the late twenties, it acquired Roessler and Hasslacher, an established producer of heavy chemicals. Grasselli Chemical, another important concern in the same field, was also acquired.

The continuous expansion into new and growing markets continued in the years of depression. In 1931 Du Pont acquired the dyestuffs division of Newport. It built plants for the manufacture of synthetic camphor, using for its raw material the turpentine produced from the stumps of the cut-over wastelands in the southeastern states. It brought out Neoprene, a synthetic product possessing many of the qualities of natural rubber. In respect to other qualities, such as acid resistance, it is superior to natural rubber It built a plant for the manufacture of

titanium oxide, a product which has, for many uses, superseded zinc oxide The company has recently begun the construction of a plant for the production of nylon, a new synthetic fiber, which has begun to compete with natural silk in the manufacture of full-fashioned hosiery.

This is a partial list of the products which Du Pont has developed since its war activities in explosives terminated in 1918 These new products are so important that, for 1937, twelve new groups not available in 1928 accounted for about 40 per cent of 1937 sales During this decade, the company invested $109,000,000 in plant for the manufacture of these products.[2]

During the period while Du Pont was shifting its production from the manufacture of explosives, when the demand had almost vanished with the close of the World War, to new and profitable lines, the assets of the company were largely increased. Between 1922 and 1939 the significant items of the asset accounts, leaving out investments in General Motors and other marketable securities, changed as follows

	1922	1939
Cash	$ 17,960,000	$119,702,000
Notes and Accounts Receivable	15,763,000	26,017,000
Inventories	25,114,200	51,538,000
Plants, properties, and good-will	105,364,000	403,473,000
	$165,201,000	$600,730,000

During this period dividends received from Du Pont earnings, not including dividends from General Motors stock owned and other investments, increased from $5,416,000 in 1922 to $45,849,000; or, expressed in terms of percentage return on the assets employed in manufacture, from 3.25 per cent to 7.50 per cent

Future of Expanding Industries

Expansion of the asset accounts is mainly confined to the expanding industries. A live question concerns the future of expansion. Since the World War many industries have expanded, a large number have

[2] This discussion of expanding and declining industries is taken from *The Ebb and Flow of Investment Values*, by Edward S Mead and Julius Grodinsky (D Appleton-Century Company, Inc , 1939)

declined. In *The Ebb and Flow of Investment Values*, 61 industries are listed as expanding, and 50 as declining The declining industries, on the basis of the record, never come back They will not expand Among the 111 groups—625 companies—listed on the New York Stock Exchange, which formed the basis of this study, no company, unless it changed its product or service to conform with the trend of demand, as long as it continued in a field where demand was declining, ever reversed its trend from a declining to an expanding industry All that they can do in the way of new investment is in the installation of betterments to reduce costs Some industries, moreover, are approaching the declining stage. They are stationary. Stagnation is a definite symptom of decay Farm machinery, sulphur, business machines, tobacco (excluding cigarettes), fruit and vegetable canning, are industries which show symptoms of decay, in stationary profits Other industries, as time goes on, may fall from their high estate of expansion

If the increase of capital investment is to continue—not the gross increase of the period 1919 to 1930, but the increase of investment in the expanding industries—two conditions must be fulfilled (1) Existing expanding industries must continue to expand, and (2) new industries must join the expanding group Television is such an industry; air-conditioning is another. Low-cost airplanes represent a third The stenotype, offset printing, color photography, frosted foods, synthetic fiber stockings and fabrics, glass fiber products, the traveling grocery and notion store, are a few of the industries which show promise The future development of atomic power may be expected to develop a variety of applications in the field of metallurgy The utilization of paper, for example, in insulation, is making progress. Synthetic rubber is now within the field of large-scale production. There is no reason to doubt that ingenuity and research will continue to operate at increasing speed to develop new products and processes In fact, there is no visible limit—no conceivable limit—to the ability of man to conquer his environment, to adapt it to his use. All these new things mean opportunities for investment. The total productive assets—capital—of the country may not be increased. Large amounts of property are obsolete It must be written off and replaced Existing apparatus, e.g., steam-boilers, or internal combustion engines, may increase in efficiency Metals may be more durable and serviceable But the new industries will call for new capital, which opens large opportunities for new investment.

Beyond the new industries, the established industries, if the standard of living continues to rise, will be expanded. The rate of population growth, it is true, is declining. The percentage increase, which was 14.9 from 1910 to 1920, rose to 16.1 per cent in the next decade and fell to an estimated figure of only 7.6 per cent from 1930 to 1940. Proponents of the theory that the United States is economically mature make much of this decreasing rate of population growth. Professor Alvin H. Hansen of Harvard University, for example, testifying before the Temporary National Economic Committee, said, "It is my growing conviction that the combined effect of the declining population growth, together with the failure of any really important innovations of a magnitude sufficient to absorb large capital outlays, weigh very heavily as an explanation of the failure of the recent recovery to reach full employment."

In a volume, entitled *Capital Expansion, Employment and Economic Stability*, Harold G. Moulton and associates [3] present some interesting observations upon this problem of economic growth. To summarize the authors' conclusions upon production requirements: The national income in 1929 was $82,000,000,000, or $2700 per average family. Twenty-one per cent of the population had an average family income of $1000 and under, 42 per cent less than $1500 and 60 per cent less than $2000. Assuming $2700 as the minimum amount necessary for "decent" existence, more than two-thirds of American families are below that level. If, now, it is proposed and feasible to give this majority an increase in income of $1000, which permits an approach to the minimum necessary, and which may be expressed in terms of goods and services, real income purchased with the increase in money income means an increase in production of $27,000,000,000, raising the 1929 income to $109,000,000,000.

Dr. Moulton estimates that $25,000,000,000 of additional capital investment will be necessary to increase the minimum family income to $2500, to say nothing of the certainty that the upper income groups would also increase their expenditure on automobiles, housing, amusements, education and travel, thus further raising the capital investment required. In a previous volume, *America's Power to Produce*, published under the same auspices, it was demonstrated that American industry can produce, and at decreasing cost, these additional amounts of goods and services.

[3] With George W. Edwards, James D. Magee, and Cleona Lewis, Chapter IX.

We are not concerned with the methods by which this result is to be attained. It may be by an expansion of the present pension system, or by a modification of the Townsend Plan, each of which involves a redistribution of wealth by an increase of taxation falling upon the medium bracket incomes, or merely by an abatement of the interference and oppression of the system of private enterprise in the pursuit of profit from which the United States has suffered since 1933 Reasonably certain it is, however, that human wants will increase, that these wants will demand satisfaction, and that their satisfaction will produce a large increase in the demand for new investment in the production of houses, roads, motor-cars, airplanes, household appliances, improved food and clothing, education, and amusement.

CHAPTER 31

INCOME AS A SOURCE OF NEW CAPITAL

Our next inquiry concerns the method by which the capital funds for the extension of plant are provided There are many methods employed by corporation managements in accomplishing this purpose. Some of the courses of action have as their basis the use of one or more of a large assortment of financial instruments, namely, stocks, bonds, or notes. These devices, described in detail in the discussion dealing with the original accumulation of capital funds, are also used when providing new capital. It is important to note, however, that the kinds of securities and the contracts which they embody will likely differ in the latter case. These differences are due to the fact that the experience acquired in operating the business will have disclosed conditions and information important in establishing the financial position of the enterprise, which could not have been known at the time of its promotion

A company may either (1) raise money to be invested in the improvement and extension of its plant, or (2) it may acquire other corporations which possess the essential assets, or (3) gain the ownership or control of the properties of these companies It may acquire these companies, by the exchange of its stocks or bonds for the stocks of the company which owns the desired property, and merge them Or, it may, through the agency of a holding company, unite its control, through joint ownership, with the control of the other company. Again, it may sell its securities for cash and use it to buy control of another company, or it may gain control of a wanted property, by some form of lease or operating agreement The plan first above mentioned is the direct method of providing capital funds out of income or the sale of securities The second and third methods represent the indirect provision of capital funds by various methods of consolidation.

Methods of Providing New Capital

The corporation may directly provide for increasing its capital funds by one or more of the following methods· (1) The money required may be

taken out of profits, (2) stock may be issued and sold, (3) money may be borrowed, either on short-term notes or by the sale of long-term bonds.

The principle that a properly managed corporation, until its accumulated cash resources are sufficient to provide for growth, should not pay out all of its earnings to its stockholders, is followed by conservative managements This demands that a part of the earnings should be retained for the business That portion of the earnings withheld from distribution to the stockholders as dividends will appear as additions to the assets and be counterbalanced by the item Earned Surplus, appearing as a liability If, at the end of a sufficiently long period of time, it is found that the retained earnings have been wisely invested, this condition being shown by increases in the amount earned, the liability item representing the retained earnings may properly be made a part of the stock capitalization through the payment of a stock dividend.

Conservative Administration Results in Investment Out of Earnings

In addition to setting up an earned surplus, directors who manage the income accounts of their companies conservatively will make important investments in plant, equipment, and working capital, out of revenues This is the favored procedure, particularly in those instances where the capitalization of the company has been issued and exchanged for services and property of doubtful value, or where the period required for development has been unduly prolonged and current assets have been dissipated. The standard of the property will be raised through expenditures for betterments. Reserves will be established and maintained to take care of depreciation, renewal of plant facilities, bad debts, insurance, and other contingencies The practice with regard to reserves is well illustrated by the balance sheet on page 425 of the Keystone Watch Case Corporation (and Subsidiaries) dated December 31, 1937

The total amount of earnings being withheld by the management of this company on the date specified consists of reserve items of $1,183,820, together with an earned surplus of $2,417,243, or $3,601,063. The effect of its policy in the retention of earnings is shown in the books of the company in the form of liability items The placing of these items in the records automatically produces a corresponding increase in the total assets. As a matter of fact, however, a direct increase in assets is brought about only in those instances where the reserve is not a consequence of providing to maintain the value of assets up to an amount

Assets		Liabilities	
Plant	$2,494,242	Common Stock	$1,000,000
Inventories	1,883,196	Capital Surplus	359,115
Investments	25,025	Earned Surplus	2,417,243
Accounts and Notes Receivable	395,867	Accounts Payable	253,585
Cash	365,266	Res for Depreciation	944,892
Prepaid Expenses	169	Res. for Federal Normal Tax	72,498
Special Fund for Purchase of Additions to Plant	50,000	Res for Federal Surtax on Undistributed Profits	10,804
		Res for Other Taxes	16,789
		Res for Bad Debts and Other Purposes	72,738
		Contingency Reserve for Depreciation	16,099
		Special Reserve for Purchase of Additions to Plant	50,000
Total	$5,213,765		$5,213,763

shown by the books When creating a valuation reserve, the amount provided for is supposed to replace the value of an asset which has been lost or consumed only, and not add to its value However, when valuation reserves are used, increases in the assets or capital funds may be said to be accomplished indirectly. This is true for if the amounts indicated were not provided for and withheld, the total value of the assets would be a smaller amount To illustrate if the specified reserves, other than those for bad debts and other purposes and regular and contingent depreciation, plus the earned surplus, had not been retained being paid out instead, the total assets would appear as $2,500,955 They were therefore responsible for a direct increase in asset values of $2,712,810 On the other hand, if, in addition, the amounts designated as reserves for depreciation and bad debts, etc., had not been provided for and withheld, the total asset value would be $1,539,964. These valuation reserves were the basis of an indirect increase in the assets of $1,033,729.

These amounts reserved out of income are at the general disposal of the management in the conduct of the business, except when they are earmarked like the $50,000 "Special fund for purchase of additions to

plant." A fund of this kind is a segregated or earmarked sum of cash or securities which has been set aside for a specified purpose and usually is not considered as being available for any other purpose. The practice of balancing reserves with like amounts of liquid assets in the form of a "fund" is an exceptional procedure. With this single difference, the $3,601,603 of undistributed income, regardless of the liability accounts which represent it, is invested in the business wherever needed It may become a part of the plant, the current assets, or securities of controlled or other companies, as determined by the management. This reserved income is at the disposal of the business and represents capital increases provided out of earnings.

Policy of Reinvesting Income

Some idea of the extent to which corporations indulge in the practice of depending upon income for additional capital may be observed by compiling and arranging the figures appearing in statements which they have given the public direct or in making factual information known to regulating agencies In presenting data dealing with this matter, the conventional classification of corporations is used so that the making of comparisons is permitted.

Railroad Companies

The more recent experience of corporations in this area of business activity is disclosed by the data reported by Class I steam railways to the Interstate Commerce Commission as follows

Year	Total Assets (000,000 omitted)	Total Surplus[1] (000,000 omitted)	Percentage of Surplus to Total Assets
1928	$27,643	$4,632	16 8
1929	28,473	5,029	17.6
1930	28,218	4,678	16 5
1931	28,019	4,396	15 6
1932	27,890	4,095	14 6
1933	27,744	3,901	14.0
1934	27,790	3,714	13 4
1935	27,553	3,507	12 7
1936	27,167	3,350	12 3
1937	27,497	3,126	11 4

[1] "Tota_ Surplus" includes additions to property through income and surplus,

During the period under consideration, the earnings which these companies have invested, on the average, amount to 14.5 per cent of the total value of their assets. Since 1933, however, the percentage has shown a tendency to remain below the average, amounting to 11.4 per cent in the concluding year.

Public Utility Companies

The same extensive and well-arranged statistical data as that concerning the affairs of railway companies is not available in the case of public utility corporations. One of the most recent compilations [2] advises that as of December 31, 1938, there were 393 privately owned Class A and Class B electric utilities operating in the United States. These large companies, it is estimated, either on the basis of assets or revenues, comprise in excess of 95 per cent of the privately owned electric light and power industry.

The combined total assets of these companies were reported to be $17,220,617,262. Of this amount, $14,048,019,026 represented utility plant, including non-electric utility property. The reservations which were made out of the income of these companies appear in items reserves for depreciation and amortization of utility plant $1,629,181,794, other reserves, $197,710,001, capital surplus $236,631,241, and earned surplus $787,768,169, a total of $2,851,291,205. These reservations amount to approximately 16.5 per cent of the total assets.

Industrials

The practice of managements of industrial enterprises is indicated by the information contained in the table on pages 428 and 429, as of 1938.

This sample of 175 corporations operating in 26 industries shows that the proportion of the total assets in their possession which have been accumulated through income reservations varies in amount between 65.3 per cent and 28.5 per cent.

The policy of corporations in the matter of reinvestment of income, we believe to be fairly represented by the suggested figures. Of course,

funded debt retired through income and surplus, sinking fund reserves, miscellaneous fund reserves, appropriated surplus not specifically invested, and balance to profit and loss.

[2] Statistics of Electric Utilities in the United States, Federal Power Commission, 1938.

Industry	No. of Cos.	Total Assets (000 omitted)	Total Reserves[3] and Surpluses (000 omitted)	Ratio of Total Reserves and Surpluses to Total Assets
				%
Oil Refining and Distribution	16	$10,970,160	$7,164,988	65.3
Cement	4	215,867	134,847	62.4
Non-Ferrous Metals and Their Products	9	1,438,971	908,732	62.4
Toilet Preparations	6	320,408	191,572	60.0
Aircraft and Aircraft Equipment	6	130,703	77,986	59.6
Chemicals and Fertilizers	13	1,988,519	1,122,028	56.4
Automobiles	7	2,009,663	1,089,571	54.2
Chain Variety Stores	6	609,241	320,411	52.5
Building Materials other than Clay Products and Cement	11	330,148	168,788	51.1
Vegetable Oils	3	85,696	42,489	50.0
Chain Grocery and Food Stores	4	164,236	80,510	49.0
Containers, Metal and Glass[4]	12	661,920	316,340	47.7
Steel	9	5,801,163	2,733,440	47.1
Motion-Pictures (Producers and Distributors)	4	275,332	129,637	47.0
Dairy Products	4	479,765	222,054	46.2
Agricultural Machinery and Tractors	6	955,739	438,325	45.8
Office Machinery and Equipment	5	164,195	71,248	43.3

				%
Clay Products	4	$80,193	$33,922	42.3
Tires and Other Rubber Products	6	952,428	394,299	41.3
Drugs and Medicines	8	210,000	83,142	39.6
Building Equipment	7	455,380	175,209	38.5
Department Stores	8	486,262	183,239	37.6
Distilled Beverages	5	303,453	111,142	36.6
Meat-Packing	4	951,593	342,899	36.0
Mail-Order Houses	2	597,079	207,503	34.7
Cigarettes [5]	6	781,155	223,080	28.5

the figures can be accepted only as estimates. They have to do with a condition existing upon a given date, which resulted from actions taken during a period of time. At another date, the percentage could appear as a different amount. They provide no information as to the extent to which corporation surpluses have been divided among the stockholders, nor is any consideration given to the sources or the methods by which the total surplus was made to appear. Estimates of corporate savings made upon the basis of comparative corporation surpluses from 1909 to 1929 indicate that the amounts are susceptible to wide variations. From year to year, these differences are directly related to fluctuations in business conditions. During the period of the first Great War, because of the exceptionally large profits enjoyed, substantial amounts of income were reinvested. In the year 1921, however, a year of depression and poor income, corporate savings were negligible.

The sum of the various reserves and earned surplus is generally representative of a large part of the total amount of income which has been reinvested. It is, however, incorrect to assume this sum to be the entire

[3] Exclusive of reserves mentioned, but amounts not given and assets stated at net values.

[4] Figures for the cigarette industry were adjusted by applying the same average rate of depreciation for valuations as used by American Tobacco Company, P. Lorillard, and Philip Morris, to the assets of Anton Fisher, Liggett and Myers, and R. J. Reynolds.

[5] Average rate of depreciation used by other companies applied to assets of American Can Company and included.

amount utilized for this purpose. If the management of a corporation indulges in the practice of providing excessive amounts for depreciation, or includes among the costs of production items of expenditure which are, as a matter of fact, capital outlays, the effect is the investment of earnings. There is no acceptable source of information on their amounts.

These influences and others of their kind must, of course, be kept in mind because they are significant, but their use or existence does not preclude the acceptance of the ratio of reserves and surpluses to total assets as an adequate unit of measurement.

A brief review of the data presented recalls two outstanding characteristics. First, that companies composing the Class I railway group rely upon income for their capital funds to a lesser degree than those in any other group, followed in order by public utility and industrial companies. Second, the percentage of total capital funds which are acquired from income by industrial enterprises greatly exceeds that of companies in other groups and shows a wide difference between particular industries.

Theories and Factors Underlying Practices (Income)

The conclusions drawn from the presented data are in accord with the opinion that companies operating in the different fields of public service have not built up surpluses comparable to those of unregulated companies. Managements of regulated corporations have used earnings as a minor source of new capital. Recognition of this condition, while of interest, sheds no light upon the factors which are taken into consideration by corporation managements in coming to a decision as to the sources of their capital funds. It is only natural that the amount of corporate income should have first consideration in this matter. Only under conditions where the volume of income is large enough to supply the demand for new capital funds, is the management able to choose between income and sales of securities as a source of supply. In addition, the selling of securities depends to some extent upon the income status. A second factor, also basic in its import, is the amount of new capital funds required to bring about the completion of the expansion program.

Factors Opposed to the Use of Income (Regulation Generally)

The regulation of corporations operating in the various fields of public service is familiar. Commissions are, in most instances, given authority over the issuing of securities. The practice in such matters is to set up

standards for the guidance of the enterprises and themselves. These standards are not strictly adhered to in authorizing or vetoing the issue of securities by companies subject to their jurisdiction Usually, if the purpose for which the proceeds of the sale of securities are to be used coincides with the provisions of the law or a commission ruling, if their issuance does not cause overcapitalization or disturb greatly the approved relation to be maintained between debt and stock capitalization, say, 67 per cent of debt and 33 per cent of stock, the petition to issue securities will be approved. All that is necessary to secure approval is to approximate the standards The practice governing the approval of security issues affects the psychology of the management Since the permission to issue securities is readily obtainable, it encourages the use of securities in the procurement of all capital funds

Influence of Regulation of Rates (Railroads)

The traditional theory depended upon to explain and justify the large proportion of total invested capital provided by railway companies through selling securities, places most of the responsibility upon the rate-making policy, as affecting the amount of income The rates in effect at any time are fixed in accordance with the principle that they provide a reasonable return on the used and usable invested capital. A reasonable return has been held to be one which, among other things, permits the attraction of capital funds into the industry in amounts sufficient to enable the demands of the public for service to be met. As a consequence of the application of these rules, it is contended that income enjoys a certain amount of protection, both as to adequacy and stability, and that this facilitates the attraction of capital funds. The credit standing of these companies, determined largely by income, permits their securities to be sold without too much difficulty, and at satisfactory prices. Based upon this reasoning, the policy of providing new capital funds through sales of securities rather than out of income, has been accepted as financially sound and proper.

Considered in the light of recent railway experience, this position is hardly tenable. The legislation applying to rate-making, under which carriers by rail in interstate commerce operated from 1920 to 1933, was the Transportation Act of 1920. This enactment specified that carriers be permitted to charge rates affording a fair return on the value of their properties The Act fixed 5¾ per cent as representing a fair return. The privilege applied, however, to carriers as a whole or to groups of car-

ries designated by the Commission, and not to particular carriers The rates effective at any given time might, therefore, produce a return for an individual company, which amounted to more or less than the 5¾ per cent specified. It was demonstrated, during the period of operation under the provisions of the Act of 1920, that most companies were not able to earn the rate of return which, by implication, had been guaranteed to them The outcome of this state of affairs was the repeal of the rate-making provision of the older act through the passage of the Emergency Transportation Act of 1933 The changes included in the new legislation also appear to be impotent in stemming the tide of financial embarrassment which has tended to submerge the railroads, brought about in part by unfavorable incomes Evidence pointing in this direction is found in the increasing numbers of companies experiencing embarrassment. It is officially reported, as of December 31, 1938, that 38 all line haul steam railways were in the hands of receivers and 71 in the hands of trustees, a total of 109 companies Thirty-nine of the roads included in this group were Class I railways. All of these companies operated 76,938 miles of road, or 17 per cent of the total track operated and had issued and outstanding $6,274,807,778 of stocks, bonds, and miscellaneous evidences of debt.

Rigidity of Rates

There is a second point of view on this question, also based upon the principle underlying the making of rates It takes the position that the rigidity of the rate structure governing the charges which carriers by rail make for their services, is responsible for limiting their income The directors of the companies, aware of the influence of this limitation, when acting upon the matter of retaining income for the business, govern themselves accordingly If the total amount of the return allowed is not large, due to regulation, and the demands of the stockholders for dividends is given consideration, the amount available for investment in additional assets must be relatively small. This viewpoint must assume that railway companies operating under conditions of rate regulation can earn a return equal to the amount prescribed as reasonable by the law. In addition, it contains the idea that these companies are not vested with monopoly privileges permitting incomes normally greater in amount than they would be under rate competition. The argument is open to question. The railways as a whole have not been able to earn

a 5¾ per cent return on their invested capital funds and they do enjoy advantages of monopoly It is just as correct to assume that a flexible rate structure, introducing an element of competition, would produce lower incomes and hence a smaller investment of earnings in plant and equipment This conclusion is borne out by the experience of the period preceding the inauguration of rate regulation.

Regulation of Railroad Rates vs Public Utility Rate Regulation

As with the railways, operating public utility companies are subject to rate regulation, but there are dissimilarities between them. In the first place, the scope of the regulatory power and the provision for creating an instrumentality to exercise administrative jurisdiction over public utilities originates in enactments by state legislatures Because of this, there is a lack of uniformity. Federal regulation, on the contrary, applies alike to all companies concerned Although state commissions determine the reasonableness of rates by applying the same general principles used in the case of railways, they are disposed to sanction a higher rate of return than the standard applying to railways, sometimes going as high as 8 per cent Many public utility companies, like the railways, find it impossible to reach the accepted standard rate of return, even though the rates charged are as high as the public will pay. It is not uncommon to find companies voluntarily lowering the scheduled rates, in the hope of effecting improvement in income. Everything else remaining unchanged, the disposition to allow a higher rate of return to public utility companies might very well account for the fact that a smaller proportion of capital funds has been obtained through security sales by these companies than by railway companies But it does not afford an explanation of the general policy of companies in both groups to reinvest a comparatively small amount of their income.

Regulation of Industrials

We turn now to the industrials. They were omitted from the preceding discussion because they are not directly subject to regulation of rates, or more appropriately, prices Nevertheless, their incomes as a class are larger and more dependable than those of their regulated neighbors. Of course, industrials do not enjoy complete freedom from regulation which bears upon prices. Congress and state legislatures have passed laws that are anti-consolidation and anti-monopoly in their purport.

These laws are applicable to the engagements of all corporations They are violated if it can be proven before a court that the fixing of prices is the motive underlying a contract between, or a consolidation of, corporations.

Price Policy of Industrials

One of the foremost privileges extended to industrials is the self-determination of prices charged for the goods or services they sell, subject only to the above indirect regulation In coming to a decision as to prices, the management will endeavor to apply the principle of charging what the traffic will bear—a price which will provide over the years a maximum net return. The income of these companies may be very large in certain periods of their life cycle. This is particularly true when the industry of which they are a part is comparatively new, or when the scope of its importance and the extent to which it is essential is expanding, assuming a continuously growing consumers' demand, one which has not reached its maximum volume Corporations so situated sometimes raise prices Usually the result is lowered prices. It is found to be more profitable to lower prices, increase sales, and lower fixed charges and costs per unit of output, than to raise or maintain prices. The profits on a larger volume through lowered prices are often greater Lower prices not only stimulate demand but they protect against competition. It is these factors which are important The character of the demand for the product or service of some industrials may provide a more favorable income than that produced under conditions of rate regulation This should facilitate sales of securities, but it has been shown that in every industry examined the percentage of total capital funds obtained by this method is less than in public service enterprises. The traditional theory is thus further refuted

Cost of Expansion and Adequacy of Income

There are other conditions affecting the amount of capital funds which security sales may be depended upon to provide. Prominent among them is the relation between the cost of expansion and the amount of income. If the cost is likely to be large, it may be imprudent or impossible to finance the program out of income. For example, several years ago the light and power industry had reported gross earnings of about two billion dollars a year, and expenditures of one billion dollars annually in extension of plant Constant additions to capital funds

out of the proceeds of stock and bonds sales were definitely necessary

The same procedure is followed in the life of corporations, especially those operating in the fields of public service, during the formative years. At such times, the demand for their services, which as public servants they may not deny, usually makes necessary the undertaking of a disproportionate amount of extension and expansion. At the same time, their costs of operation are often burdened with expenses due to the necessity of correcting errors of omission and commission made in bringing about the efficient functioning of the property. Thus, when the need for capital funds is somewhat exaggerated, incomes are insufficient and corporations find themselves forced into the capital market to obtain the funds they require.

Another relationship believed to have much to do with the processes of obtaining additional capital is that between the total invested capital and the total sales. Where the total capital turnover is small, that is, where the number of dollars invested to produce one dollar of sales is large, additional capital funds tend to come from security sales and from income where it is large The Class I railways, on December 31, 1938, reported total invested capital of $31,922,691,000, and total revenues of $3,752,808,785 or $8 50[6] of capital for each $1 00 of revenue The combined total assets of the 393 electric utilities previously referred to was $17,220,617,262, their total revenues were $2,548,532,153,[7] or an investment of $6 75 of capital for each $1.00 of revenue For the industrials, the picture was quite different in 1938, as shown in the table on page 436

In no instance, in these industries, is the total invested capital per dollar of sales as great as that of railways and public utilities But it is plain that, in the quartile of industries where the approximation is closest, are to be found two-thirds of those industries which have obtained the largest proportions of their total invested capital out of income And the quartile where the approximation is most remote includes one-half of the industries obtaining the least of their capital funds out of income The influence of total capital turnover can be considered important, subject to the qualification that it is a major factor only insofar as regulated industries are concerned.

[6] Statistics of Railways in the United States Interstate Commerce Commission, 1938

[7] Statistics of Electric Utilities in the United States Federal Power Commission, 1938

	Total Capital Invested per $1 00 of Sales	Percentage of Reserves and Surpluses to Total Assets
Chain Grocery and Food Stores	$ .291 +	49 0
Meat-Packing	481 +	36 0
Mail-Order Houses	652 +	34 7
Dairy Products	711 +	46 2
Vegetable Oils	.812 +	50 0
Cigarettes	837 +	28 5
Chain Variety Stores	854 +	52 5
Department Stores	.925 +	37 6
Toilet Preparations	.940 +	60 0
Aircraft and Aircraft Equipment	990 +	59 6
Distilled Beverages	1 013 +	36 6
Drugs and Medicines	1 124 +	39 6
Automobiles	1 251 +	54 2
Motion-Picture Production and Distribution	1 342 +	47.0
Containers (Metal and Glass)	1 522 +	47 7
Tire and Other Rubber Products	1.562 +	41.3
Office Machinery and Equipment	1.600	43 3
Building Materials other than Clay Products and Cement	1 781 +	51 1
Agricultural Machinery and Tools	1.815 +	45 8
Building Equipment	1 919 +	38 5
Oil-Refining and Distributing	2 828 +	65 3
Chemicals and Fertilizers	3.066 +	56 4
Non-Ferrous Metals and Products	3 567 +	62 4
Steel	3 695 +	47 1
Clay Products	4 138 +	42.3
Cement	4 308 +	62 4

Influences Favorable to the Use of Income. Effect upon Capitalization

The managements of corporations depending upon income as a major source of capital funds must be influenced by the prospect of advantages from their plans One of the most important benefits lies in the fact that this capital practice has no effect upon capitalization. The new cap-

ital funds are acquired without the selling of stocks or bonds The amount of securities previously issued and outstanding remains undisturbed. Of course, this is true only when the management refrains from declaring and distributing stock dividends The unfavorable effect of withholding income from direct distribution to stockholders is frequently overcome by taking this step The principal amount of stock of many industrials originated in this manner for reasons which were discussed in the chapter on surplus The payment of stock dividends is not necessarily complementary to the investing of income The management, investing income, without making provision for stock dividends, obviates all prospective criticism having to do with the matter of overcapitalization or "watered" stock The problem of the subsequent burden of fixed charges in the form of interest too large in amount for the earnings to carry, does not arise The established policy of dividend distribution will not be disturbed With the relative proportions of debt and ownership securities comprising the capitalization kept inviolate, there is eliminated any ground for complaint by their owners of a serious change in their status as security holders

Improved Credit Standing

The increase in the capital funds of corporations, as revealed by their aggregate assets, is generally responsible for an improvement in their credit standing When income is used to effect these increases, the long-term debt is not changed And, except for short periods and temporary loans for construction purposes, the debt liabilities are not increased. Ultimately, the ratio of total invested capital to total indebtedness increases, and credit, should emergency borrowing become necessary, is improved

The discussion of depreciation showed that accurate calculation of proper rates of depreciation admitted to be essential, leaves much to be desired. Particularly is this true when the loss is due to "business obsolescence," brought about by largely unpredictable changes in demand These elements of uncertainty may be largely eliminated by a policy of retention and reinvestment of earnings This is equally true of any other contingency which should be guarded against.

Payment of Income Taxes by Stockholders

Aside from advantages coming directly to the corporation through extension out of income, it may benefit indirectly The fact that the

stock of many prosperous corporations is owned by small groups of individuals is familiar. These persons are obliged to pay income taxes, the amounts of which tend to reach formidable figures, because surtaxes, graduating upward in percentage, are levied on incomes included in the higher brackets Keeping tax payments to a minimum is a matter of importance A dividend received on the owned shares of domestic corporations, in any form other than stock, must be included in the reported taxable income. A convenient way of keeping taxable income as low as possible is to withhold from distribution as dividends the income of the controlled companies The non-payment of dividends, other things being equal, could benefit the company indirectly by providing a market for its stocks among persons of large income

Objections to Dependence upon Income for Capital Funds

It has long been considered inappropriate for the directors of public corporations, that is, those whose stocks are widely held and upon whose dividends many owners depend for a part of their revenue, to pursue a policy of relying upon income as a primary source of new capital. The companies have applied to the public to furnish funds for their enterprise, and they have been contributed with the implied understanding that if profits were earned, so far as distribution could safely be made, they would be paid out in dividends The directors of public corporations can not therefore, while keeping faith with their stockholders, withhold income for plant investments beyond the maintenance of proper reserves, and the investment of surplus earnings over conservative dividend payments. If the business is profitable and requires new capital, the feeling of the stockholders is that the stocks and bonds of the company shall be increased in order to obtain new capital, and that they shall not have to forego the receipt of dividends for an indefinite period in order that an ultraconservative policy should be carried out If the business needs new funds, the stockholders are usually willing to supply it, provided they have been treated fairly in the matter of dividends

There are other objections to any plan of depending entirely upon profits to provide capital funds Profits are irregular, and it is often difficult to carry out a suitable program of improvement while depending exclusively upon the business to provide the funds therefor Furthermore, the situation frequently demands that comprehensive projects of

improvement should be completed within a short time, instead of spreading them over a series of years at the expense of the stockholders Earnings may not be sufficient to allow the required speed.

Assume, for example, that a corporation wishes to construct a new plant which will cost $1,000,000, and that 10 per cent will be earned on the cost after the work has been completed The concern has annually $200,000 of profits available for either the payment of dividends or meeting the cost of the newly constructed plant The undertaking can be brought to completion in three years out of profits, plus a bank loan of $400,000 to be retired in two instalments If stocks or bonds are sold, the time required for completion will be one year Over a period of five years, therefore, by the method of using the profits, the earnings from the new plant would amount to $200,000, less interest on the loan at 6 per cent, $36,000, or $164,000 net, making a total profit for the entire property for five years of $1,164,000 If the funds had been acquired by an increase of stocks or bonds, the earnings from the new plant would be $400,000, less the amount paid as the cost of the new capital in the form of interest on bonds or dividends on stocks. In this sort of transaction a matter of more importance from the standpoint of the stockholders' interest is the fact that, if the profits are utilized in acquiring the new plant, they may not be paid as dividends, and only $164,000 could be distributed as such, but, by using the method of selling stocks or bonds, the $1,000,000 of earnings ($200,000 in each of five years) from the original property, together with the balance of the $400,000 earned by the new property, may be distributed as dividends.

Effect of Reinvestment upon Stockholders' Interests

A policy of "plowing back" all of that part of the corporate income representing earnings can be carried out only at the expense of dividend payments on the stock There is divided opinion relative to the merits of this procedure One view holds that it is to the advantage of the holders of stock to withhold all or a major portion of the earnings for utilization by the business. The opponents believe that the interests of the stockholders are best served by distributing earnings as dividends. The effect of each practice is shown below, based upon the assumption that $1,000,000 common stock is sold to acquire assets valued at $1,000,000 and 10 per cent is earned on this value over a ten-year period. If all earnings are plowed back the result would be

	Total Assets	Earnings During Each Year
Beginning of 1st Year	$1,000,000	$100,000
Beginning of 2nd Year	1,100,000	110,000
Beginning of 3rd Year	1,210,000	121,000
Beginning of 4th Year	1,331,000	133,100
Beginning of 5th Year	1,464,100	146,410
Beginning of 6th Year	1,610,510	161,051
Beginning of 7th Year	1,771,561	177,156 10
Beginning of 8th Year	1,948,717 10	194,871 71
Beginning of 9th Year	2,143,588 81	214,358 88
Beginning of 10th Year	2,357,947 69	235,794 77
End of 10th Year	2,593,742 46	

If all earnings are distributed as dividends, the result would be

	Total Assets	Earnings During Each Year
Beginning of 1st Year	$1,000,000	$100,000
Beginning of 2nd Year	1,000,000	100,000
Beginning of 3rd Year	1,000,000	100,000
Beginning of 4th Year	1,000,000	100,000
Beginning of 5th Year	1,000,000	100,000
Beginning of 6th Year	1,000,000	100,000
Beginning of 7th Year	1,000,000	100,000
Beginning of 8th Year	1,000,000	100,000
Beginning of 9th Year	1,000,000	100,000
Beginning of 10th Year	1,000,000	100,000
End of 10th Year	1,000,000	

By way of comparison, under the first method one share of stock (par $100) retained by the original stockholder for ten years, would have a book value of $259 37, a gain of $159.37 It is also probable that the market value has improved. By the second method, the stock would have a book value of $100, no gain being added, but instead, $100 per share was received in dividends over the ten-year period. The sum of the book value and dividends amount to $200, or $59 37 less than in the first method The investment of dividends received at compound interest is supposed to more than offset this difference. If the amount of dividend is invested at 10 per cent, it would produce a principal amount of $159 37 per share. Adding this to the book value of $100 per share gives the same figure as that obtained under the first plan. Therefore, the only way a plan of paying dividends may prove

advantageous to a stockholder who retains his stock, assuming the company earns 10 per cent on all capital accretions, results from investment of the dividends received at a return in excess of that earned by the assets of the corporation

The situation is changed somewhat when the sale of stock is contemplated The relation of market price to book value becomes now the important factor. No matter whether the profits are retained or paid out, the market value of the stock may be more or less than its book value This depends largely upon a favorable comparison of its yield with the average on similar risks

If, where the earnings are retained, the return is sufficiently above the average to permit sale of the stock at $400 per share, $140.63 above book value, a profit of $300 per share will result In order to receive the same monetary revenue when the earnings are divided and invested at 10 per cent compounded, the stock would have to be sold at $240.75 and to gain an advantage the market price must be above this figure. This would be the case, provided market prices of stocks paying dividends tend to exceed book values in greater proportion than those of non-dividend payers, because stockholders place a higher value upon dividend paying stocks

A compromise plan may be adopted. A part of the required additional capital funds may be provided out of income and the balance through sales of stock, thus conforming to the theory underlying new capital contributions. Changing the facts in the original assumption so as to provide for paying 60 per cent of the earnings as dividends, reinvesting the remainder, together with the proceeds of sales of stock at par equal to the dividends paid, the result would be

Beginning	Assets	Earnings	Div Paid	Surplus	New Stock	Total Stock
1st Year	$1,000,000	$100,000	$60,000	$40,000	$60,000	$1,060,000
2nd Year	1,100,000	110,000	63,600	46,400	63,600	1,123,600
3rd Year	1,210,000	121,000	67,416	53,484	67,416	1,191,016
4th Year	1,331,000	133,100	71,461	61,639	71,461	1,262,477
5th Year	1,464,100	146,410	75,749	70,661	75,749	1,338,226
6th Year	1,610,510	161,051	80,293	80,758	80,293	1,418,519
7th Year	1,771,561	177,156	85,111	92,055	85,111	1,503,630
8th Year	1,948,717	194,872	90,218	104,654	90,218	1,593,848
9th Year	2,143,589	214,359	95,631	118,728	95,631	1,712,576
10th Year	2,357,948	235,795	102,755	133,040	102,755	1,815,331
End of 10th	2,593,743					

The book value of each share of stock at the end of the period is now $142.88. If the original stockholder purchased his proportionate share of the new stock issued, the book value of his total holding will be $259.37, which is the same amount as shown where all earnings were retained. In other words, the earnings merely passed through the hands of the stockholders. As in the case where earnings were all paid out as dividends, any advantage depends upon the results obtained from investing such income. If the dividends received were invested for the period at 6 per cent compounded, they would amount to $83.91 which, added to $142.88 of book value per share, would show a loss of value amounting to $32.58. The advantages coming to a stockholder in this case are subject to the qualifications previously set out.

The benefit enjoyed by stockholders as a consequence of a policy of paying all or a portion of earnings to them as dividends must also suffer reduction by the amount of payable income tax. This item becomes increasingly important as stockholders' incomes enter the higher brackets. In the final analysis, the stockholder will benefit from reinvestment of profits only if corporate earning power is maintained. Only then will market price of the stock approach or exceed book value. Otherwise the stockholder would be better off, in that he has dividend income to spend.

Directors' Good Faith Sometimes Questioned

The withholding of earnings from stockholders creates a bad impression. The charge is frequently made that the controlling interests, who usually occupy lucrative positions in the company organization, and who often receive secondary and indirect emoluments as a result of their positions, practice discrimination against the stockholders. It may be imputed that a policy is being pursued which, while increasing the value of the company's property by withholding earnings, is causing a lowered market value while adding to the cost of the stock which represents the ownership of the corporation owning the property. Stock for which $100 per share was paid, no matter if 10 per cent is earned per year, if dividends are not paid, will in ten years represent a cost of $160 at simple interest and more if it is compounded. No matter how much money goes into the property, if nothing is given to the stockholders, the demand will be weakened and the supply increased.

Modification of Theory Underlying New Capital Contributions

The original theory underlying the acquisition of new capital funds had for its basis the idea that such amounts were to a large extent to be contributed by the owners of the already issued and outstanding stocks or bonds, or by others in exchange for additional issues of these instruments This practice was encouraged by profit distributions. Recent business developments indicate that certain modifications of this concept are necessary, especially in the fields of manufacturing and trading In a previous chapter, mention has been made of the many and formidable obstructions which beset the pathway to business success The greatest of these hazards is obsolescence, not only "out-of-dateness" of machinery and methods, but change of demand affecting profits The classic illustration of obsolescence as a business phenomenon is the effect of the change in the scope and volume of women's dress upon the textile industry The anthracite coal industry has suffered from the introduction of other fuels, oil, gas, coke, and bituminous coal, into the field of domestic heating The danger of competition is always present Labor troubles may seriously affect profits Business depression is always a possibility. Tariff disturbances are often threatened

When capital is contributed by the stockholder, he has a moral right to dividends if they are earned This right to dividends is of primary concern to him. If more capital is needed, he expects to increase his contribution and be paid a return at least equal to that received on his present investment As a condition of his support he demands that dividends should be maintained A suspension of dividends is regarded as a misfortune.

If the income of a company is large enough to pay liberal dividends (6 to 8 per cent are usually considered sufficient), while providing funds ample for profitable expansion, that are equal to the economical construction of additional plant facilities with the necessary additions to working capital, then the excess income should be used for expansion As already shown,[8] betterment investments, whose returns can not be calculated as accurately as those derived from additions, should be made out of income.

[8] *Supra*, Chapter 26

Policy of Providing Capital out of Profits

This is a policy of safety. It is the method followed by many of the most profitable corporations—General Motors, General Electric, Eastman Kodak, Allied Chemical and Dye, the largest cigarette-making companies, the metallic container companies, some of the oil companies and many others. These corporations may declare stock dividends. They may purchase the stocks of other companies with their own stock, even assuming the bonds of such absorbed companies, but the construction and equipment of their own plant is made out of funds accumulated from income. This practice does not exclude new capital issues when these can be made on favorable terms, but it recognizes that the safest, and therefore the best, method by which a company can grow is out of its own income.

Starting from the standpoint of security, a supplementary rule based upon the discussion may now be formulated, viz., the greater the risk, the larger must be the reserves for contingencies, and since these reserves are usually invested in the business, the contributions of capital funds out of income vary directly with the estimate of risk.

The self-financing trend of industry has been summarized by Dr. Oscar L. Altman, Securities and Exchange Commission economist, in the following statistics presented to the Temporary National Economic Committee:

1. That in no year since 1922 have business enterprises relied upon the capital markets for as much as $2,000,000,000 of new savings in any one year for the purchase of new plant and equipment, despite average annual expenditures of $8,500,000,000 for the years 1923-1929 and of $5,800,000,000 for the period 1935-1937;
2. That the major sources of funds for the construction of plant and for the purchase of machinery and equipment has been business savings plus funds set aside as depreciation and depletion allowances, and
3. That the funds set aside by business enterprises for depreciation and depletion have in recent years been 50 per cent greater than they were in the early 1920's.

For the period 1923-1929 business enterprises financed more than 75 per cent of their average annual expenditure of $8,500,000,000 for plant and equipment from internal sources; for the period 1935-1937 they financed 92 per cent of their average expenditure of $5,800,000,000 a year from internal sources.

Depreciation and depletion allowances for all business enterprises, unincorporated as well as incorporated, doubled from 1920-1929 They rose from $2,500,000,000 in 1920 to $5,100,000,000 in 1929 and are estimated at $4,600,000,000 in 1937.

Corporation Income Tax and Reinvesting of Earnings

The policy of the federal government in the matter of taxing corporations has not only produced, over a period of approximately thirty years, legislation providing for the imposition of many kinds of taxes upon business, but it has also been responsible for frequent changes in the basis of levying taxes upon the incomes of corporations These changes have, as a rule, provided for an increase in the aggregate amount of taxes to be collected, and, at the same time, often varied the proportion of the tax burden to be borne by corporations in different income groups

The maximum income-tax levy was that based upon the terms of the Revenue Act of 1936. This legislation specified a normal tax rate of 15 per cent upon normal tax net income in excess of $40,000 and a graduated tax on undistributed profits up to a high point of 27 per cent, thus a total tax of 42 per cent was imposed on portions of the income of certain corporations The tendency toward increasing the rate of taxes to be paid by corporations was relaxed by the passage of the Revenue Act of 1938, its terms eliminating all but 1½ per cent of the tax imposed on undistributed profits The Revenue Act of 1939 omitted the tax on undistributed profits, although increasing the rate of normal tax.

The requirement that corporations must pay a normal rate of tax on their incomes is a circumstance of minor importance in its relation to the problem of earnings as a source of capital funds. Income tax of this kind, like items of wages, salaries, materials, losses in asset values, insurance, interest, rentals, etc., is a charge against corporate income. Generally speaking, it becomes significant only at times when its amount becomes disproportionate to other charges, or to income The payment of an amount of tax, calculated by applying the rate fixed to the taxable income is mandatory, and the financial policy of the management is not concerned in any way, except to make certain that necessary cash is available for meeting the obligation

A tax on the undistributed profits of corporations is, however, a mat-

ter quite different from a normal tax on their incomes. An impost of this kind may have a very decided effect upon the financial policies formulated and executed by managements. If the plans contemplated using earnings as a source of capital funds, a satisfactory judgment could not be arrived at without some consideration being given to the tax law This is so because the amount of taxes corporations would be obliged to pay would increase directly with the amount of profits earned but withheld from distribution in particular years. Taxes on income, distributed or undistributed, as the case may be, are a business expense Corporation managements have a lively appreciation of the benefits which come from keeping expenses to a minimum. They are committed to the adoption of practices and procedures which will bring about such a condition. It is reasonable, therefore, that they be expected to use every device at their command to keep the amount of income taxes payable as low as possible In attempting to bring this about, however, they may be confronted with the proposition that amounts of profits distributed as dividends reduce the aggregate capital funds which may be needed for the conduct and development of the business. Such funds would have to be replaced through the sale of stocks, bonds, or notes, unless the provisions and administration of the law permitted some alternative action

This latter condition was applicable to those provisions of the above mentioned income-tax laws levying a tax on undistributed profits If a corporation succeeded in realizing a satisfactory amount of profits in a taxable year, but found its position with respect to capital funds was such as to make payments of cash dividends undesirable or unsound, the law made available a number of ways, by means of which the profits could be retained and the obligation to pay taxes abated. This was possible if, in lieu of payments in cash, profits were distributed (a) in property, (b) in their own credit obligations, (c) in their own stocks which when received would be taxable as income of the recipient, and (d) in their own stocks which, while not taxable as income of the recipients, were issued in connection with a choice allowed shareholders to take cash instead of stock

The effect of a law imposing a tax on undistributed profits upon a policy of providing new capital out of income is expressed either in the amount of taxes payable or in the capitalization of the corporation. Previously, if income was withheld from distribution and reinvested, the

capitalization remained undisturbed, unless stock dividends were declared and distributed But during the period these laws were in effect and corporations paid the least possible amounts of tax on undistributed profits while withholding their income from distribution, capitalizations automatically increased.

CHAPTER 32

THE PROVISION OF CAPITAL BY COMMON STOCK ISSUES

Assuming now that funds are to be raised for extensions by the sale of securities, the first question concerns the class of securities to be sold Shall the corporation increase its stock, or shall it borrow the money needed?

Rights of Stockholders to Participate in New Issues

The capital stock of a company represents its ownership This ownership is divided into shares An increase of the amount of stock increases the number of shares If there is only one kind of stock, the shareholders, when it is proposed to increase the capital, have two alternatives. They may take the new stock themselves. In this event, their shares in the company's profits remain unchanged Or they may agree to offer the stock for general subscription If a corporation has $10,000,000 of capital stock and proposes to add $1,000,000, each stockholder of record has the right to participate in the increase The holder of one hundred shares of stock, for example, will be allowed to subscribe to ten shares of the new stock This would give him the same proportion of interest in the corporation that he had before It frequently happens, however, that existing stockholders do not take the entire issue. Stock must then be sold to outsiders who are admitted to share in the earnings, and to share in the control of the company on equal terms with the existing stockholders.

Dangers in the Admission of New Interests

To the controlling interests of a company the entrance of new stockholders is a matter of concern. New stock coming upon the market may be used to wrest control from those who now hold it. Especially if, as usually happens with large companies, the control represents no more than a minority, there is danger of losing it

A celebrated instance of this result was the ousting of Mr. August

Belmont and his associates from the directorate of the Louisville and Nashville in 1902. Early in that year the directors, in order to finance some extensions, authorized the sale of 50,000 shares of stock Under the rules of the New York Stock Exchange, shares were not deliverable on contracts until thirty days after they had been issued. Funds were needed immediately, however, and in order to obtain them, the chairman, Mr Belmont, was instructed by the Board to sell 50,000 shares "short"—that is to say, he sold stock which he did not own, borrowed the stock to deliver what he had sold, and expected to take up the loan out of the new shares when these should have become deliverable. At the same time, however, unknown to the Belmont interests, a syndicate, headed by Mr John W Gates, was engaged in a campaign to purchase control of the company, and, in the course of their operations, they developed a short interest estimated at 120,000 shares, including the 50,000 shares sold by Mr Belmont.

The directors of the Louisville and Nashville had, in other words, sold more shares than they owned, and they could obtain the stock to make their deliveries only from the syndicate whose advantage it was to bring about this situation On April 14, 1902, it was discovered that a corner existed in Louisville and Nashville, the price of stock (which had been 107½ a month before), on this date touched 133. A repetition of the May panic of 1901, which was brought about by a similar operation in Northern Pacific stock, seemed imminent Under these circumstances, short sellers who must obtain shares to repay their stock loans must pay whatever the owners of these shares demand, or go into bankruptcy. Northern Pacific common stock under these conditions had reached $1,000 a share only the year before with very large declines in the general level of stock values caused by the forced selling of other stocks to meet the Northern Pacific calls Serious trouble was averted, however, by the recognition by J P Morgan and Company, acting in behalf of the general situation, that Mr. Gates and his associates controlled the Louisville and Nashville, and by the purchase of a majority interest in that company by the Atlantic Coastline Railway through the bankers at a figure which rendered a large profit to the Gates syndicate

Effect of Stock Financing on the Credit Position of a Company

An important consideration influencing the selection of stock as a source of new capital is the resulting strengthening of the capital credit

position The accepted rule is to sell junior securities, preferred and common stock, when these can be sold to advantage, and to reserve senior securities for sale in periods of depression when the public appetite for stock is not keen, and when bonds are in demand. It is evident that the smaller the amount of bonds, the lower are the fixed charges, and the greater is the margin of safety in net earnings over charges. When capital liabilities include a large percentage of stock, bonds can be sold at a higher price than when the capital structure is mainly composed of bonds.

The policy of the American Telephone and Telegraph Company is a striking illustration of the value of following this plan The bonds of this company amount to approximately 16 per cent of its capital issues (1939) [1] The Interstate Commerce Commission, so far as it has been able to do so, has always insisted that railroad companies should include a large percentage of stock in their capital issues Every effort is made, when new stock is issued, to persuade stockholders to increase their holdings, or, failing in this, to obtain assurance that the new interest shall not only be such as will strengthen the position of the company, but will not be unfriendly to those in control The strongest inducement which can be offered to a stockholder is to sell him a safe investment at a low price, and the lowest price which the law allows for par value stock is par, the figure at which the stock is usually offered to stockholders

The Privileged Subscription

This prohibition against the sale of stock below par (unless such a step is necessary to save the company from serious embarrassment), limits the opportunity to raise capital by the sale of common stock to companies whose profits and dividends are so large that their stocks sell well above par Here again appears an important advantage of stock without par value. With par value stock, a sale at par is possible only when dividends and prospects are so large and rosy as to raise the price of the stock substantially above par, and to hold it above par in the face of an increased supply of stock. With stock of no par value, however,

[1] The credit of the company and the safety of its bonds will be further strengthened by the completion of a plan announced on November 24, 1940 to refund nearly $100,000,000 of callable bonds at a substantial saving in interest The plan anticipates private sale of the new bonds to institutional investors.

on the basis of any market value whatever, even $10 per share, a privilege can be offered to the holders, because the stock can be sold to them below market value

The existence of these stock premiums, which reflect high dividends and assured earning power, makes possible the financing of strong companies by the sale of common stock to their stockholders. This plan is known as the sale of privileged subscriptions.

Implications of Stockholders' Rights to Participate in New Issues

At common law, new stock of a corporation must first be offered to the existing owners Only if they are unwilling to buy, can stock be opened to general subscription. Great care must be taken to comply with this provision unless the incorporation law and the charter specifically provide otherwise which is now quite common.[2] With the growing use of convertible bonds and subscription warrants, devices for making securities more salable by some process of "sweetening," commitments for future stock delivery are reaching large amounts In order to legalize such future stock deliveries, e g, in exchange for convertible bonds or warrants, the bonds or preferred stock which carry these conversion or subscription privileges should first be offered to stockholders. If they accept the offer, the amount to be sold elsewhere, to bankers or to investors direct, is reduced. To the extent that stockholders do not take the new securities, they can then have no valid ground of complaint that their proportionate interest in the company is reduced by the sale or issue of new stock. But if the offer is not made, and convertible bonds are sold direct to bankers without giving *every* stockholder of record the right to participate in the new issue in the ratio of his ownership interest, the new issue might not be legal

Objection has been made to this view that, by their action in authorizing the sale of convertible bonds, stockholders waive their right to participate in the stock privileges of the issue Such a right, however, is fundamental, embodied in the original contract between the stockholders and the corporation, and it can not be waived by any indirect method. It must be specifically surrendered, if surrendered at all, and by each

[2] The Incorporation Act of Pennsylvania, section 611, states that "unless otherwise provided in its articles, a business corporation may issue shares, option rights or securities having conversion or option rights, without first offering them to shareholders of any class or classes"

stockholder. The action of the constitutional majority can not operate to deprive any stockholder of his fundamental right to retain his proportionate interest in the corporation

An illustration of the care taken in these matters was the May 6, 1929, recommendation of the Diamond Match Company, which proposed to sell, on preferential terms, a large amount of stock to companies which handled its products, that Diamond Match stockholders should *ignore* the offer of this stock first to be made to them by the company, in view of the great benefit which they would gain from the affiliation of other interests by the sale to them of this stock Specific waivers of this right to subscribe to new issues, leaving directors free to dispose of new stock as they see fit, have also been noticed in recent incorporations, indicating a belated recognition of the existence of this fundamental right of the stockholder which, of course, can not be insisted on if it is formally surrendered in the fundamental contract between the corporation and its members

The attempt of the British General Electric to sell stock on preferential terms, well below the market price, to British stockholders, excluding American stockholders from the privilege, aroused great resentment in the United States, based on the violation of their legal rights which the proposal involved The American Stockholders' Committee took the stand that their right to participate in the new issue was paramount to every other consideration, even to the necessity alleged in justification of the actions that the highest interests of the British corporation demanded its control by British citizens. In this connection, it was not denied that Parliament, by appropriate legislation, may restrict ownership in British companies to British citizens, and that this action could operate to deprive foreigners of voting and subscription rights in such companies Such legislation is taken under the general right, in the public interest, to amend, or even revoke the charter.

Position of Stockholders When Stock Is Issued for Property

The same common law rule would seem to apply when stock is issued for property Even if the stockholders, by the constitutional majority, authorize the issue of stock for property which is valuable to the company, and which can not be obtained except in exchange for stock, unless and to the extent that the stockholders so assenting to such issue of stock for property expressly, in the form of their assent, surrender their

right to participate in the new stock, the purchase of the property may be considered as an infringement on the rights of stockholders It is true there are decisions in the state courts—the latest in Maryland—which appear to take the issue of stock for property out of the operation of the general rule that new stock must first be offered to stockholders of record But it is difficult to see how, if things that are equal to the same thing are equal to each other, if the stock sold for money with which to buy property must be offered to stockholders, that stock issued directly for property must not first be offered to them. The reason in the one case is the same as in the other, the right of the stockholder to preserve his proportionate interest in the company. Stockholders not voting for the issue of stock for property should not be deprived of their rights by the action of the majority.

Danger of Exploitation of Minority Stockholders

Such issue of stock for property can be used to dilute to the vanishing point the interest of the original stockholders. In such matters stockholders usually follow directors' lead, and accept their recommendations For example, a large and influential stockholder in a paper manufacturing company might own or option certain water powers which he had not funds to develop By allying himself with the large stockholders whom he might admit to participation in the gains of the undertaking, he might be able to kill two birds with one stone to sell his water power for stock of the manufacturing company and, at the same time, establish himself and his friends in a large majority control In such a case, stockholders interested only in the manufacturing company, while unable to block the purchase in any other way, could, by insisting on an offer of the new stock for cash to all stockholders, retain their proportionate interest The law should protect stockholders' rights even though, through ignorance or indifference, they allow the directors to toss them away In a case like the above, where a practice long continued was used to dilute the stockholders' interest in a corporation, and where the plain intent of the directors is to so dilute it, relief could probably be found in a court of equity in spite of the fact that the long continued practice sanctions the ignoring of the rights of stockholders when stock is issued for property

In order to make this important point entirely clear, we must remark that the stockholders' right to participate in new issues is limited to a

refusal of the new stock. In order to retain his proportionate interest, he must *buy* his share of the new issue. If he refuses to subscribe, he cannot complain if other men step into his shoes

"Dilution" of Value of Stockholders' Privileges

The same question is frequently raised, when warrants are issued in series corresponding to successive issues of stock, the first warrants, for example, carrying the right to subscribe to new stock at $30 a share, the second at $25 a share, and the third at $20 a share, the price being reduced because of the condition of the company or the condition of the stock market. Arrangements are always made in such cases to lower the subscription prices on the earlier issues, and this, as expressly stated, is to prevent any "dilution" of the stockholder's interest The same protection is given the stockholder in the event of stock dividends, or split-ups, which may reduce the market value of the shares

A method of selling stock below par, even though the law apparently prohibits such a sale, when the issuing company has a surplus, is first to declare a scrip dividend, making the scrip exchangeable for stock at par, then offering stock at par to the stockholders who may pay part of the purchase price with the scrip.

Advantage to a Company from Selling Stock at a Premium

When stock sells at a high premium, new issues may be offered at a price above par. In case the market value of the stock is realized by offering stock at a premium, a smaller number of shares need be sold to obtain a given amount of capital than if stock is sold at par Suppose, for example, that $1,000,000 is required by a company whose stock can be sold at 150, paying 10 per cent dividends. If the stock is sold at market value, 6,666 shares will be needed to obtain the $1,000,000 necessary If it is sold at par, however, 10,000 shares will be required. The amount necessary to pay the 10 per cent dividend on 6,666 shares is $66,666, while on 10,000 shares $100,000 would be required. If the stock is sold at a premium, $33,333 of annual dividends, assuming that the 10 per cent rate is continued, can be saved for the company, below the dividend payments which must be made if the stock is sold at par. As a result, the rate of dividend can perhaps be increased, and the price of the stock advanced on the strength of its larger dividend returns.

In view of these facts, the directors may decide that they should

make the best bargain for the company, that the stockholder shall derive no advantage as a subscriber from his position as part owner of the corporation, that he should be treated as any other investor. Furthermore, under the plan of selling stock at a premium, no more stock will have been issued than is necessary to provide the amount of money required. The higher the price of the stock ascends, borne up on the rising flood of dividends, the smaller will be the number of shares to be sold to obtain the same amount of money The Pennsylvania Railroad Company, for example, has received large sums as premiums on stocks sold. Without these premiums, which were invested in the business, the outstanding stock of the Pennsylvania might have been materially greater than it now is

On the other hand, if stock is sold at par, or at less than market price, the corporation must issue a larger number of shares than would be required to furnish the desired capital if the market price was obtained It may be impossible, on account of the issue of this extra stock, to do more than maintain the regular dividend, and the price of the stock, therefore, may not advance to the point which it would reach, did the directors sell at the best price they can get.

In the case of public service corporations, the principle has been established that they shall not be allowed to earn more than a fair return on the value of their property (usually 6-8 per cent). In some states also, a corporation may not increase its stock beyond the amount necessary to secure funds for capital expenditures In Massachusetts, for example, the issue of all bonds and of any increase of stock in excess of the original capital is limited to such amount as the railroad commissioners shall, after a public hearing, determine will realize the sum which has been expended on the property and which is to be restored to the treasury out of the proceeds of stock sales, or the sum which will be reasonably required by the corporation for new construction

As a rule, however, a company whose stock sells at a premium does not attempt to obtain any part of the premium by a public offering, but offers its stock to its owners at par.

Profits on Privileged Subscriptions—How Realized

The stockholder receiving the privilege can avail himself of it, either by selling his right to subscribe to the stock, which is made assignable for the purpose, or, by selling a certain portion of his holdings after

he receives the evidence of his right to subscribe, at the market price, replacing these shares at par out of the new issue, or, he can retain his stock and take the new shares as well In the first two cases—the sale of the assignable right to subscribe, or the sale at the market price of an amount of stock equal to that to which the stockholder is entitled to subscribe at par—he makes a profit which equals the market premium of the stock, times the number of shares which he sells Since the right to subscribe at par will ultimately only be purchased by a prospective stockholder, its price is less than the difference between par and market value Unless the intending subscriber can obtain his own stock at a lower price by purchasing a right which he then exercises to obtain new stock, he will prefer to buy the stock direct

Method of Calculating the Return on High Dividend Stock Sold at Par

If the stockholder is unwilling either to sell his right to subscribe or to part with any of his stock, the privilege apparently gives him an opportunity to increase the return he receives on his investment Suppose he has purchased the stock of a company paying 6 per cent dividends for $150 His return is 4 per cent The company, within five years after he has purchased the stock, offers to stockholders the privilege of subscribing to new stock at par to an amount equal to 80 per cent of their holdings. This stockholder, instead of selling the right to the stock, prefers to increase his investment on the favorable terms offered. At the end of five years, he owns 180 shares on which the annual return is $6 per share, or $1,080, on an investment of $23,000, or 4 7 per cent There is little doubt that this is the course followed by the majority of stockholders when privileges are offered to them

By the correct method of computing the yield on investments, however, the return on a stock should be obtained by dividing into the rate of dividends, not the cost price, but the market price. An investor who takes advantage of a privilege to buy a 6 per cent stock for $100 per share which is selling on the exchange at $150, has only a 4 per cent investment, since a share of stock represents to him $150 of capital and $6 of income The investor, however, usually estimates the return by comparing the cost of the stock with the rate of dividend, and this belief influences him to hold fast to stock, new issues of which are occasionally sold to stockholders at less than market value In no other way

could the failure of shares to show heavy declines after the announcement of privileges be explained. Some decline is usually experienced following the announcement of a privilege, but it is seldom sufficient to warrant the conclusion that a large number of stockholders are disposing of their shares. There is no reason for them to do so if they have confidence in the value of the stock, since they can take their profit at any time by selling, at a premium, stock which they purchased at par.

Advantages to the Corporation in Selling Stock to Existing Stockholders

When a corporation proposes to increase its stock, the directors must keep in mind not merely the amount of money which the new stock will bring, but the effect of the issue upon the composition of the stockholding body, the necessity that the subscription should be a success and that the money should be promptly forthcoming, the desirability of being able to obtain capital from the stockholders when required, no matter what the condition of the money market, and to any amount that may be necessary, the justice and expediency of extending to stockholders more liberal treatment in the matter of subscription than they extend to outsiders, and, finally, the fact that the sale of a privilege is equivalent to an increase in the rate of dividends

Advantage of Permanence in the Composition of the Stockholding Body

Let us take up these considerations in order The sale of stock at a high premium means that new interests are brought into a company, and that its stockholders are continually changing Existing stockholders, many of whom will have purchased the stock at much lower prices than those prevailing at the time an attempt is made to secure a premium from a new issue, will have no inducement, other than their general confidence in the company, to increase their holdings at higher prices than those which they previously paid While a large amount of a new stock issue may be taken by existing stockholders, much of it will be sold to outsiders These new interests may have their preferences for directors and officers, and their influence may disturb the management and control When, however, stock is sold at par with a valuable privilege attached, based on the existence of a high premium in the market, the stock is very closely held Little is offered for sale, since the stockholder

of record knows that, from time to time, in addition to the yield on the stock represented in the dividend paid, he will have an opportunity to increase his holdings on more favorable terms, or, if he desires, to gain an immediate profit in one of the ways described.

The firm holding of stock, which is increased by privileged subscription, is the more certain because the values of stock privileges are not, as a rule, fully expressed in the market price of the stock. If a corporation whose earnings were rapidly increasing should announce that, on January 1 of each year, its stock would be increased 10 per cent, and that stockholders of record would have the privilege of subscribing to the new stock at par, in proportion to their holdings, the value of the privilege would be expressed in the market value of the stock, which would be established on a higher level than the cash dividend, in the absence of these assured privileges, would warrant. No such assurance, however, can be given to the stockholders. The directors will follow the policy which seems best at the time. They can not limit themselves in the methods which they will employ for raising new capital. It is impossible, therefore, that these privileges should be counted upon as a regular source of profit. They are incidental gains to the stockholder, which he has every reason to believe he will receive in the future as in the past, but which will not be fully reflected in a higher market value of the stock, although it is true that the market price of a stock which has been favored by privileged subscriptions is usually higher on that account. To gain the full value of these privileges, the stockholder must retain his shares. Corporations which have granted valuable privileges have a body of stockholders whose membership changes slowly.

Directors place a high value upon permanence in their stockholding body. Stockholders of long standing can be counted on to support the management. In the unlikely event of a contest for proxies, the limited supply of such a stock makes it very difficult and expensive for an outside interest to buy control. One of the most serious difficulties experienced by Mr. Harriman, in his contest for the control of the Illinois Central in 1907, was the firmness with which most of the individual stockholders supported Mr. Stuyvesant Fish's administration.

Risks Involved in Offering Stock at High Prices

Another argument in favor of selling stock at par to stockholders of record is that the securing of a premium on the sale of a large amount

of stock is an uncertain matter, depending on the condition of the stock market, which may change overnight. Here is another argument for the privilege subscription. To make sure that a premium will be secured, the services of an underwriting syndicate may be necessary The Pennsylvania Railroad, for example, in 1903, offered $75,000,000 of stock to holders of record at $120 a share. The stock was at that time selling above 150 No difficulty was anticipated in selling the stock to the Pennsylvania stockholders A general decline in stock values, however, set in, which carried down the value of the Pennsylvania stock with it. As the price went down, the directors feared that the stock might fall below the subscription price before the date when the subscriptions were to be made In this event the credit of the company would have been seriously damaged, since the subscription offer would fail. No matter how loyal the stockholders were, they would not pay the company more than the market price for the new issue

To guard against such a misfortune, an underwriting syndicate was formed, headed by Speyer and Company, which, in return for a commission of $2,250,000, agreed to take from the company any of the $75,000,000 of stock at the subscription price of $120 a share, which the stockholders should not take The announcement of the formation of this syndicate steadied the price which had at one time fallen to $114½, and the syndicate had to assume only a small part of its obligation, making a large profit on the transaction. The Pennsylvania Railroad was at that time probably the strongest railroad corporation in the world, and its stock was highly esteemed by investors On this occasion the stock was offered to stockholders far below the market price, and yet the securing of a premium was only made possible by the intervention of an underwriting syndicate

On the other hand, a corporation whose stock sells at a high premium and which offers new issues to stockholders at par can sometimes raise large amounts from this source During 1906, when the bond market was seriously depressed, and when the strongest railroad and industrial corporations, rather than sell long-term bonds on a 5 per cent basis, were resorting to the expedient of short-term notes paying 5 and 6 per cent interest, four of the largest railroad companies—the Great Northern, the Northern Pacific, the Chicago, Milwaukee and St Paul, and the Chicago & Northwestern—raised about $300,000,000 from their stockholders, by the sale of stock at par If they had gone into the bond

market, it would have been difficult for them to obtain this amount of money at reasonable rates They might have paid for three years an interest rate of at least 6 per cent on notes issued in anticipation of the sale of the bonds.

The sale of stock on a privileged basis to holders of record is fair to the stockholder who does not care to increase his investment, and who would not be able to share in any of the benefits of the new issue, if it were offered at a premium Such stockholders receive their rights to subscribe, which they can sell in the manner already explained, and in this way share in the benefits of the high and assured earnings which made the premium possible

Sale of Stock Below Market a Method of Distributing Surplus

The issue of premium stock at par to stockholders is an indirect method of distributing the company's surplus in the sense that a larger distribution must be made in dividends than if this has been sold at a premium A corporation which obtains $1,000,000 by selling 10,000 shares of stock at par, when it could have obtained the same money by the sale of 6,666 shares at $150, as assuming a larger dividend burden than is necessary to obtain the money Its stock capital is 3,333 shares larger than it would have been had the full market price been obtained. The dividend rate can not be increased as rapidly as though a smaller number of shares had been sold to obtain the amount required For this reason, the sale of privileged subscriptions by public service corporations has been criticized There is a tendency in public sentiment to compel these companies to sell their stock at the highest market price obtainable, and not to favor stockholders by the sale of stock on preferential terms.

Position of the Interstate Commerce Commission on Privileged Subscriptions

The law takes no account of the market value of stock. It merely requires that the par value should be paid in cash, and in the absence of a special statute or ruling to the contrary, the corporation has authority to sell its stock at par. Furthermore, market value, as already shown, is unstable and uncertain. The realization of a given profit by the sale of a privilege, which, as we have seen, is a course adopted by only a portion of the stockholders to whom privileges are offered, is a doubtful

matter. The Interstate Commerce Commission, in the case of the City of Spokane v. Northern Pacific Railway Company, considered this question of the return from privileged subscriptions, in reaching a conclusion as to the earnings of the Northern Pacific The complainants in this case asserted that the Great Northern, one of the defendants in the case, had distributed its stock, from time to time, in such a manner as to give its stockholders large profits in addition to their dividends, and insisted "that this manner of selling stock is vicious and unlawful, and that, in determining the return to these stockholders, we must have in mind the benefit conferred upon those stockholders by this operation"

The Commission, however, rejected this view as follows

> Assuming, without deciding, that the complainant is right in its position, that this practice is both unlawful and unwise, how can we, in this proceeding, take any practical note of what has been done? This stock is selling today, upon the market at something less than $120 per share. If the original stockholder has retained and now owns his stock, he paid $100 in the beginning, has received a regular dividend, and now owns his stock at the above advance. While the profit to him has been a handsome one, there is certainly nothing here which would call for a penalizing of the stockholder Suppose, now, that, instead of retaining the stock, the stockholder sold the same to some innocent purchaser, who paid the market price, and who has continued to own the stock from then until now This present stockholder paid perhaps $264 a share for his stock He has lost $144 per share. Should we, for that reason, compel him to sustain a further loss? The manner in which this stock has been manipulated may furnish a strong argument against the propriety of permitting the sale of new stock in this manner, but so far as this particular company and the stock already issued are concerned, the transaction is ended, and can be given no practical consideration in determining what rates shall be charged by the Great Northern Railway Company

The commission in 1928 reversed its former position temporarily when it finally gave permission to the Chesapeake and Ohio to sell stock at par in order to finance the purchase of Pere Marquette stock

The practice of issuing privileged subscriptions, without restrictions, will not, in all probability, be continued by the public service corporations. Railroad companies since the War have mainly relied upon bonds as a source of capital funds Only since 1924 have stock prices advanced so as to bring up the question of privileged subscriptions. However, with the more rigid control now exercised by public service commissions,

including the Interstate Commerce Commission, over security issues, directors will probably be required, when selling new stock, to obtain the highest possible price. This does not, however, mean that stockholders will not longer be favored with opportunities to subscribe on preferential terms, but merely that the value of the preference may be reduced If a public service commission is required to authorize an issue of stock selling at a premium, and to name a price at which the stock can be sold, unless they wish to take the responsibility for a possible failure of the subscription, they will not insist that the corporation should attempt to obtain the full premium ruling at the time the offer is made. Some lower figure will be named, and at this figure the stockholders of record will be allowed to purchase

Sale of Stock to Customers

Another method is the successful effort of public utility companies, beginning about 1918, to sell securities direct to their customers, in this way making their customers their partners. The purpose of such policies is not only to obtain money at lower cost than bankers' commissions, but to build up a public following among the citizens which can be appealed to and aroused in defense of their own interests if the public service corporation is attacked It has been found possible to sell preferred and even common stocks of many utilities to customers on terms quite favorable to the issuing company, much more favorable, in fact, than could be obtained from bankers for securities of a much higher grade. One important reason for this success was the availability of the employees of the companies, especially those of a higher grade, as salesmen, and the usual contact of the community with the service which the company renders [3]

Utility companies in recent years have disposed of large amounts of preferred stock to their customers by the agency of those employees who come into direct contact with the public.

Customer ownership conciliates public opinion. It also creates stock equity on the strength of which the company may be able to obtain more favorable terms on bond or preferred stock issues from bankers.

[3] The Public Utility Holding Company Act of 1935 prohibits a holding company, by mail or other instrumentality of interstate commerce, to cause an officer or employee of a subsidiary to sell any holding company securities

Customers are natural buyers of securities of the companies which supply them. The plan is apparently limited to utilities, where an extensive cultivation of a local field brings results

Employee Ownership

Employees' ownership is partly philanthropic, partly politic in motive It is not to be relied on as a source of capital funds, but merely as a means of establishing friendly relations between the company and the management and to reduce the turnover of labor.

The danger in admitting employees to partnership lies in the possibility of a suspension of dividends In such an unfortunate event, goodwill would quickly turn to hatred and the last state of the corporation will be worse than the first.

CHAPTER 33

SALE OF SENIOR SECURITIES

In Chapter 17 we have explained the advantages of trading on the equity. They may be summarized here as the obtaining of money by the sale of fixed interest or preferred dividend obligations, and the use of these funds in the business of the corporation assuming the capital produces a profit greater than the amount of interest and/or preferred dividends. The margin between interest and preferred dividends, and the profit earned on the money so obtained, measures the advantage of trading on the equity.

Certain qualifications and amendments of this simple statement must be noted. First, a distinction must be made between the profits earned on preferred stock money, and the profits earned on the proceeds of bond sales. Under the old practice, which railroad corporations followed, with the exception of equipment trust obligations, it was unusual to include in the bond and mortgage contract any provision for a sinking fund. When the bonds of a given issue matured, they were replaced by another bond issue, either sold to obtain funds for cash payment of the maturing bonds, or by exchanging, on some attractive basis, the maturing bonds for the new bonds. This venerable practice, which has led to so much disaster, has now been abandoned for railroad bond issues. Before the collapse in railway securities, due to excessive reliance upon borrowed money for development and to the failure to reduce debt by amortization, industrials, real estate, and some electric railways had adopted in their borrowing the rule of sinking funds. This is now universal. Most light and power company bonds are protected by sinking funds.

As a matter of practice, therefore, the profits to be earned by using the proceeds of bond issues must be large enough not merely to pay interest rates, which, for the present at least, are very low, but to retire all, or a substantial amount of, the debt before maturity. Maturities, compared with the old practice in railroads, are also short. Fifteen years is the term most often met with, and it is customary to

retire at least half the debt before maturity by the operation of the sinking fund. In this situation, the current advantages to the common stockholder of trading on the equity are much reduced. To illustrate, a company borrows $5,000,000 at 4 per cent for 15 years. On this $5,000,000 it expects, one year with another, to earn 10 per cent, which is a very good average return. Interest is $200,000. The company should also pay within 15 years $2,500,000 of the debt, or $166,666 per year. The savings in interest on the bonds retired by the appropriations to the sinking fund are usually added to these appropriations. As a matter of current gains by the stockholder from this transaction, the sinking fund reduces this distributable margin to $133,334 per year, or $2,000,010 during the life of the bond, if the expected 10 per cent average return is realized. At the end of the period, the company owes $2,500,000 and must make arrangements to pay or refund this amount.

This profit on the proceeds of the bond issue is not to be despised. On $5,000,000 of stock, a fair division between stock and bonds, it is 27 cents a share per year. If profits are figured on the accrual basis, giving effect to the periodical reduction of the debt, they are about double that amount.

These profits, however, are the reward of risk-taking. To obtain the $5,000,000 by selling bonds, the borrowing company promises to pay, within 15 years, $3,000,000 of interest and $5,000,000 of principal The proceeds of the bonds are invested in the business They may be, in part, kept liquid As a rule, however, they are invested in plant and equipment, specialized to the use of a particular business, coal-mining, baking, steel-making, electric light and power, or building construction Every business, as already explained in the discussion of depreciation, is exposed to risk The railway industry, as an industry, for example, twelve years ago was considered to be riskless It was the perfect source of investment income. Railway companies borrowed in that conviction. This opinion, events have shown, was wrong. A third of American railway mileage is now in the hands of bankruptcy trustees Nearly $4,000,000,000 of railway bonds have, within three years, been excluded from the list of investments legal for New York savings-bank investments. This progressive infection of insolvency has spread widely throughout the industrial structure The list of declining industries given in Chapter 30 is long Corporation managements, with these horrible examples of risk-taking constantly before them, are very cautious in borrowing

money. In relation to their earnings and to the amount which they could borrow, they exemplify the most extreme caution Many of the soundest and most profitable companies, as we have seen, do not borrow The borrowing companies keep down their debt to low figures, compared with their ability to pay interest Earnings over interest of most industrial borrowing companies show very wide margins of safety. Standard Oil of New Jersey, for example, for 1939 reported interest of $9,682,-000, and net income over all charges of $89,129,000. This was nearly 10 to 1. National Steel reported 6 to 1, Bethlehem, slightly less, Goodyear Tire and Rubber, 7 to 1, Allis Chalmers about the same. In some cases, the margins of safety were much larger Aluminum Company of America, 40 to 1, Anaconda Copper, 19 to 1, Sun Oil, 30 to 1. In any proper use of the term, these ratios do not show a reliance upon long-term debt as a source of capital funds These corporations can borrow at the lowest rates of interest. Their profits from trading on the equity are very large. But their main reliance for permanent capital is upon other sources than debt

Even when sinking funds are added to fixed charges (and it must be remembered that while a sinking fund is a fixed charge, failure to meet a sinking fund payment, as a rule, does not lead to bankruptcy), the margin of safety in earnings over charges is impressive. With fear and trembling does modern corporation management venture into debt

Failing the sale of bonds for whatever reason, and assuming a need of new capital which management either will not, or can not, meet out of profits, or from the sale of common stock, there remains preferred stock. This security is, from the corporation's standpoint, safe. The solvency of no company has ever been endangered by the maturity of preferred stock, or by the necessity of paying dividends on such stock All claims of the preferred stockholder are conditional, provisional, contingent If profits are not made, or if, though earned, the directors do not consider it wise to pay them in preferred dividends, the preferred stockholder must wait. He may, if his contract with the company contains that provision, after a long or short period, if his dividends are not paid, take over control of the company. His dividend claims (preferred stock almost universally contains the cumulative feature) may pile up, but only against the common stock, never against the company. Neither of these stipulations for his benefit are of much benefit to the preferred stockholder whose dividends are in arrears.

They are indeed fair to the eye, in outward seeming, but they do not avail to give him income when his dividends are not earned.

Of course, as a matter of fact, although not of law, the bondholder is in precisely the same situation as the preferred stockholder The payment of his interest is secured by the contract with the company. This contract contains many and formidable teeth His trustee, acting under his orders, must, unless the trustee wishes to retire from his trusteeship, enter upon and operate the property of the defaulting borrower, he may apply for a receiver, he may, after suitable interval, reduce the claims to judgment, or, if the bonds are secured by mortgage, the trustee may secure a foreclosure sale, or the bondholders, acting through a committee, may buy in the property and become the owners. All this is very imposing and reassuring to the bondholder. These provisions should and, until they are put into operation, do make him happy and confident in his investment. As one investment manager, in response to a suggestion that he sell some coal bonds now in default, remarked with solemn emphasis, "Do you realize that these bonds are secured by a *first lien* on this vast property, containing hundreds of millions of tons of coal?" Of course they were so secured, but since coal sales were declining and earnings with them, bankruptcy was not long delayed, when interest on these bonds was promptly stopped An illustration of the fallacy that property, as such, furnished security for bond issuers, is furnished by the West Virginia Coal and Coke Company

This company, which was incorporated in 1924 as a reorganization of a company of the same name, organized in 1917, owns and controls 26,900 acres of coal lands and coal rights underlying 89,000 additional acres, together with coal leaseholds of 40,000 additional acres, containing about 800,000,000 tons of recoverable bituminous coal It operated, in 1924, 40 mines with an annual output of 3,500,000 tons, and it employed 3,000 men. Its mines were well equipped, and it enjoyed the immense advantage of non-union labor with a $5 00 wage scale as compared with $7 50 in the competing union fields Its assets were valued at $31,000,000, against which as a prior lien were $7,000,000 of 6 per cent, 25-year mortgage bonds. These bonds were further protected by a sinking fund of 5 per cents per ton on all coal mined and shipped during the first 5 years, 7 cents during the second 5 years, and 8 cents per ton thereafter Minimum annual payments under this sinking fund were $250,000 during the first 5 years, $300,000 during the second 5 years,

and \$350,000 thereafter. The mortgage securing these bonds was closed. No additional bonds would be issued Surely here was the ultimate in bond security. An immensely valuable property, producing a necessary raw material at low cost, with the entire property back of the bonds.

Explanation of the Default

On May 9, 1929, the court decreed a sale of the property for the benefit of the bondholders and the company was to be reorganized

The statement of the committee follows in part

The industry The bituminous coal industry is in a period of readjustment, not only in this country but abroad The readjustment was caused by the excess production developed during the World War, coupled with the growing use of substitutes, such as fuel oil and electric power There have also been developed many economies in the use of coal, thus further limiting demand. The readjustment has been prolonged by frequent strikes, which have tended to keep alive the inefficient mines and the competition they furnish In this country the situation has been further complicated by changing freight rates and the unsettlement of markets thereby caused.

Results of the Readjustment The readjustment has brought two developments. The first has been a constantly declining price for soft coal Lower prices have brought lower earnings, if not deficits, and as earnings are the support to property values there has been a serious decline in the values of bituminous coal properties

The second development has been the growth in the demand for a better product. It is now necessary to produce cleaner and better prepared coal than ever before.

Both of these developments make necessary the investment of new capital. The low prices must be met by the introduction of such cost-reducing machinery as has been proved efficient, and the facilities for good preparation must be provided

Failure of the Industry. It seems likely that low prices and the necessity for the investment of new capital will ultimately force many mines to close It is also probable that economies in the use of coal cannot be extended as rapidly as in the recent past In time competition should become less severe and the natural growth of the country be reflected in a growing demand for coal How long it will take to complete the readjustments is impossible to determine, and it would be dangerous to reorganize any soft coal company on the theory that improvement is near at hand

Situation in West Virginia. The mines of the West Virginia Coal & Coke Co are all in the State of West Virginia They have been under the same

influences as the industry generally. But West Virginia mines have also to face two new problems. As non-union fields, they formerly had an advantage over several other important fields which were operated by union labor This advantage has been lost with the gradual change to non-union conditions elsewhere and the wage reductions made in union fields The second problem arises from the fact that there has been a change in freight rates on coal shipped to the Great Lakes in favor of the mines of Pennsylvania and Ohio. This makes it necessary for West Virginia mines to sell at lower prices in order to hold their markets.

It is not difficult to understand, from such developments as the above, the change which has come over the investor in his attitude toward mortgage bonds These West Virginia properties, for example, were enormously profitable during and after the War. Their owners drew large sums in dividends Then they obtained new capital, when the cream had been skimmed from the proposition, by selling first-mortgage bonds. The bondholders were faced with the offer of 40 shares of new common stock for each $1,000 bond, with the option of paying $1,240 for a unit of $1,000 bond and 24 shares of stock, to furnish the company with $2,000,000 of additional new capital, so that a new management could make an earnest effort to retrieve its fortunes This effort was not successful. The company has earned nothing Its operations, in fact, show a deficit. In spite of its vast coal land holdings, or rather, because of them, since taxes are based on real property, this company is not a success.

Property security, for a company whose profits and/or liquid assets can not pay its interest charges, is worth little as a protection to bond creditors They may, and do, as in the illustration just given, acquire title to the property. They may recapitalize, giving themselves all the stock They may comfort themselves and prevent future defaults by accepting income bonds which, in point of security, are little better than preferred stock These measures can have no bearing on the real situation, a lack of earnings.

Still, this reverence for secured bonds, sanctified by long usage, and still persisting in full force in law, custom, and prejudice, has important consequences The management, seeking new capital, and hesitating between the sale of bonds and preferred stock, must take account of the investors' preference for bonds The stipulated dividend rate on preferred stock issued by the same company, except in reorganization exchanges, is higher than the interest rate on an equal par value of

bonds, secured or unsecured. Bonds are easier to sell. They do not require the same inducements in the form of conversion or subscription privileges which, under normal conditions of the money market, are necessary to market preferred stock. Their market is much broader. Institutions—savings banks, commercial banks, and trust companies—may buy bonds, but not preferred stocks. Life insurance companies, the largest source of investment funds, are limited in preferred stock purchases, but may buy bonds which meet the legal requirements, without limit. Trustees, unless a will or a deed of trust makes exceptions, are limited to bonds and mortgages. Because of this wholesale institutional demand, investment bankers are anxious to buy bonds.

Management must take account of these preferences. Other things being equal, they can obtain money more readily and on easier terms by selling bonds than by the offer of preferred stock. If they decide to take the plunge, to go into debt, management is pushed strongly into the bond market.

There is another situation often met with. A company whose earnings have been shrinking because of declining demand for its product or service, feels compelled to do something radical, to introduce some new line, or more often, to install new equipment to lower costs and improve quality. American railroads, during the decade following the World War, borrowed for this general purpose. Their credit was good, but their earnings were not sufficient to warrant large stock sales, since the stocks had par value and could not be sold at less than par. Preferred stocks, at 6 per cent or 7 per cent dividends, were not attractive. The bond market, however, welcomed the railway borrower.

It is easy to see at this distance that much of this borrowing was ill-considered. At the time these large loans were made, however, there were few to criticize. Even junior bonds, with only nominal flavors of seniority, were readily sold to—and by—conservative investment bankers, and purchased by financial institutions of the highest repute.

So great is the reverence for bonds, especially when secured by liens on property, that instances are not lacking in those industries which operate with large fixed capital, the heavy iron and steel industry, for example, where the investor disregarded recent earnings in favor of property. Jones and Laughlin Steel Company, for example, in 1936 sold $30,000,000 of mortgage bonds, although the three years preceding showed a net loss. Pittsburgh Coal, and Philadelphia and Reading

Coal and Iron made large loans in 1929, mainly for rehabilitation purposes, although the previous showing of earnings was not impressive. The prospectus of the bond issue of the Coal and Iron Company quoted the statement of the Stone and Webster Engineering Company that the investment of the proceeds of the $30,000,000 bond sale would, *under assumed normal* conditions, show earnings, due mainly to resulting economies, of more than double the interest charges on the new debt The assumed normal conditions never materialized, the company defaulted, and is now in process of reorganization with heavy loss to the bondholders indicated

Our final inquiry in this brief discussion of long-term capital borrowing, concerns the type of bonds to be issued. From the standpoint of the corporation, wherever a junior issue can be sold, the issue of first-mortgage bonds is usually to be avoided Mortgage bonds are senior securities When junior securities can be sold, first-mortgage bonds will be held in reserve for future sale The reason for this preference is a reason of caution The time may come when the market will take only first-mortgage bonds, when a resort to the use of senior credit offers the only way out of an embarrassing situation It is of importance, therefore, to keep the senior line of credit open. A similar situation exists in commercial borrowing When money is easy and commercial paper in demand, a well-managed concern will obtain its requirements in the commercial paper market, leaving its regular bank credit lines open Then when money tightens, and commercial paper is hard to sell, resort is had to the banks. Because they have had the company's deposits during periods of easy money, the banks are under a moral obligation to take care of its requirements when money is scarce So, in the long-term capital market, if debentures without special security, "plain bonds," can be sold at a fair price, they are sold, and available first-mortgage bonds are held back for emergencies. The investment banker favors this selection for two reasons He can make a higher commission on the sale of junior securities, and when this market vanishes, he is glad to have high-grade first-mortgage bonds to offer

Protection Given to Debenture Holders

Debentures, as we have seen, can be well protected by various covenants. The application of the proceeds can be controlled. New issues can be limited, in the same way as issues out of a mortgage bond reserve,

to a percentage of the cost of property acquired, or they can be protected by stipulations that a certain margin of earnings must be maintained, or by the requirement that a given percentage of the amount must be kept in liquid assets. Debentures can be made more attractive by conversion or stock purchase privileges and they sell, of course, at attractive prices. When the bankers insist upon the requirement that new mortgages must protect existing debentures, there is this obstacle to subsequent senior financing, that the amount of bonds authorized under the mortgage securing the senior issue must be made large enough to include the debentures. But this restriction is not always insisted upon. It is really opposed to the interest of the debenture holders, since mortgage financing is sometimes the only way to avoid a receivership. When an emergency arises, they can sometimes be persuaded to waive this covenant in the interest of necessary senior financing. Even if the covenant is not waived, debentures usually carry sinking funds, and, if the sinking fund has been in operation for a considerable time, a margin has been built up for financing with first-mortgage bonds, which will take in the debentures.

CHAPTER 34

THE CHANGING PATTERN OF NEW CAPITAL ISSUES

The pattern of new capital issues varies with the condition of the long-term capital market. This expresses the relationship between the demand for long-term capital and the supply of funds saved, which are seeking investment From 1921 to 1938, three periods can be identified 1923 to 1929, inclusive, expansion, 1930 to 1932, depression, and 1933 to 1937, recovery In the fall of 1937, a mild depression set in, extending into 1939. In the fall of 1939, business improved and the improvement, under the stimulus of war demand, has continued to the date of this writing

The first of these three periods, while showing a moderate increase in national income, was an investor's paradise. The index of combined interest and dividend payment, based on the returns of 655 corporations listed on the New York Stock Exchange, computed on an average of 1928-30 as a base, rose from 62.4 in 1923 to 103.5 in 1929, an increase of 41 1 points, compared with 17.4 points for the national income. Most of this increase in distributed profits was in common stock dividends, and common stock prices rose to correspond The following table shows, in terms of a comparison between 1923 and 1929, the increase in market value of a representative list of common stocks.

APPRECIATION IN STOCK PRICES, 1923-1929

NAME OF COMPANY	APPRECIATION, IN POINTS	APPRECIATION, PER CENT
Air Reduction	159	220
Allied Chemical	85	76
Allis Chalmers	89	175
American Can	409	382
American Locomotive	34	23
American Smelting	117	170
Amer. Tel & Tel	65	50
American Tobacco B	161	101

APPRECIATION IN STOCK PRICES, 1923-1929—*Continued*

NAME OF COMPANY	APPRECIATION, IN POINTS	APPRECIATION, PER CENT
Anaconda	17	32
Atchison	90	86
Baltimore & Ohio	45	75
California Packing	40	46
Chesapeake & Ohio	76	90
Consolidated Gas	91	132
Corn Products	120	75
DuPont	412	278
General Electric	470	235
General Motors	46	271
Gillette Safety Razor	84	29
Hudson Motors	19	59
International Harvester	162	165
International Tel & Tel.	88	124
Kennecott	53	118
Liggett & Myers B	161	71
Loew's, Inc.	19	90
Montgomery Ward	23	88
Nash Motors	286	251
National Biscuit	88	169
New York Central	53	49
North American	42	175
Otis Elevator	237	155
Packard Motor	67	446
Paramount-Famous-Lasky	12	13
Public Service of New Jersey	111	218
Radio Corporation	22	550
Reynolds Tobacco B	46	61
Southern Pacific	11	12
Standard Oil of N J.	4	9
Union Carbide	110	164
Union Pacific	56	39
United Fruit	60	32
United States Steel	97	80
Western Union	36	30
Westinghouse Electric	43	64
Woolworth	23	8

Shift from Bonds to Stock

Out of this situation came a marked shift from bonds to stock as a means of providing new long-term capital The extent of the shift is shown by the following table which gives the total corporate issues during the six months ending June 30, for five years, and shows this change from bonds to stocks.

YEAR	LONG-TERM BONDS AND NOTES *	STOCKS, INCLUDING NEW CAPITAL AND SECURITIES ISSUED FOR REFUNDING *
1929	$1,872,199	$3,487,134
1928	2,666,437	1,590,056
1927	2,804,247	887,004
1926	1,917,982	764,535
1925	1,722,552	578,541
TOTAL	$10,983,417	$7,307,270
Average for 5-year period	2,196,683	1,461,454

* 000 omitted

The amount of bonds and long-term notes show a moderate change during the period, declining sharply in 1929. Common stock issues moved steadily upward till 1929, and more than doubled in that year The investors' preference turned to equities Profits were large and increasing and the investor wished to participate This preference for equities affected the type of bonds issued. Few bonds were issued during this period without conversion or stock subscription privileges. By adding stock option provisions, these companies met the wishes of the investor, and they were able to sell at good prices many debenture and second-grade mortgage issues which, in the absence of such provisions, would have been difficult to dispose of

After 1930, the situation changed. The full effect upon the security market was not felt until 1931 During the six years ending in 1935, including 1930, the total volume of security issues fell to low figures, to an average of $247,000,000 per year from 1933 to 1935. For the entire period of depression and recovery, the amount of securities sold

reached \$4,000,000,000, less than the amount of securities sold in a single year—1929. Compared with the period preceding, the demand for long term capital has fallen to very low levels.

Security Issues after 1930

We are not concerned with the causes of this phenomenon. The fact must be admitted that the demand for long term capital, measured by the sales of securities from private enterprise, has greatly declined. At the same time, the supply of funds seeking investment has greatly increased The volume of savings, measured by the increase in assets of banks and insurance companies, was over eight billions greater in 1938 than in 1934. This represented an institutional demand for bonds, not for stocks Institutions are not, generally speaking, allowed to hold stocks in their portfolios unless the stocks are taken in connection with reorganization or liquidation proceedings At the same time many sources of bond supply—railroads, street railroads, farm and urban mortgages, have, since 1930, almost dried up, leaving industrials and light and power companies as the two main sources remaining in the field of private industry The borrowing power of the large municipalities has also tended to decline This left the securities of the Federal Government as the main source of investment supply Not only were large government loans incurred to meet the recurring national deficits, but government agencies, such as the Home Owners Loan Corporation, borrowed large sums on the security of the government guaranty of their obligations. The old standard of financial management has been abandoned and the public debt, in time of peace, has advanced to very high figures.

As a result of this rising demand for sound investments, the market yields on first grade bonds, a combination of interest rates and market prices, fell on the average about 25 per cent from the figure of 1929, 23 per cent for A-1 corporation bonds and 27 per cent for municipals. This decline has been due rather to lower interest rates (3 and 3 5 per cent are now common) than to higher prices. Bonds are usually callable and they have been freely called It is impossible for the price of a callable bond (or preferred stock) to rise much above the call price.

The effect of this development, scarcity and high prices of sound industrial securities, modified the long-term capital policies of business corporations. The percentage of stocks, both preferred and common, to the total volume of securities issued, has declined Out of a total of

domestic corporate securities of \$6,023 millions issued from 1931 to 1939, inclusive, to obtain new capital, only \$1,425 millions consisted of stocks—a reversal of the trend from 1925 to 1930 The best industrial corporations as already shown in Chapter 31 aside from a few groups —oil, steel, rubber, and paper—the most important divisions of industry which have issued bonds, have financed the greater part of their capital requirements out of profits. Those which have appealed to the investor for funds have divided their issues between bonds and preferred stock.

The following table, which covers a five-year period, 1935-39, shows the division between the different classes of securities issued to obtain new capital from 1935 to 1939.[1]

Classification of Issues

	(\$00,000 omitted)				
	1939	1938	1937	1936	1935
Long-term bonds and notes	275 1	803 1	769 1	824 5	323 0
Stocks	91.6	63 3	408 0	367.5	69.3
Short-term bonds and notes	4 5	3 6	47 8	23 0	11 3
TOTAL	371 2	870 0	1224 9	1215 0	403 6
Stocks	91 6	65 3	408 0	367 5	69 3
Bonds and notes	279.6	804 7	816 9	847 5	334 3

These figures are for new capital In addition, \$9.7 billion dollars were issued for refunding Nearly all of these refunding issues were bonds Most of the securities issued for new capital, as shown above, were bonds.

Of the total amount of securities issued to obtain new capital, 1.4 billions represented the offerings of railroads and public utilities (light and power) companies, about equally divided between the two classes Railway new capital securities were mainly equipment trusts, the only form of security now available for most railroads.

In passing, we may call attention to the comparatively small issues of utility—light and power—bonds to obtain new capital. Although the light and power industry is rapidly expanding its output, the political atmosphere was not favorable to new financing. The light and power companies met the demand by readjusting the plants, e.g., replacing

[1] The figures are taken from the compilations of the *Commercial and Financial Chronicle*

	($00,000 omitted)				
	1939	1938	1937	1936	1935
Railroads					
Long-term bonds and notes	85 0	16.0	227 1	248 3	72 8
Short-term bonds and notes			4 5	19 1	
Stocks				3 8	
TOTAL	85.0	16.0	231 6	271 2	72 8
Public Utilities					
Long-term bonds	51.3	265 7	143.3	117 9	81 8
Short-term bonds and notes			4.6	1.2	20.0
Stocks	5 5	5 1	6 4	4.6	1 8
	56 8	270 8	154 3	123 7	103 6

low-pressure boilers to increase their output, and within the last two years, out of earnings, sometimes by passing dividends, and by drawing down their liquid assets

Of the new capital securities issued during the last five years, $2.7 billions were sold by industrial and miscellaneous corporations.

	($00,000 omitted)				
	1939	1938	1937	1936	1935
Iron, Steel, Coal and Copper					
Long-term bonds	17.3	155 4	88 8	141 2	104 3
Stocks	2 5	1 6	41 2	7 8	8 6
TOTAL	19 8	157.0	130 0	149 0	112.9
Motors and Accessories					
Long-term bonds			5 7		5 5
Stocks	2 7		12.7	13 2	1
TOTAL	2 7		18 4	13 2	5 6
Other Industrial and Manufacturing					
Long-term bonds	39 8	92 4	103 3	60 5	213 5
Stocks	68 4	6 4	223 8	175 7	25 3
TOTAL	108 2	98 8	327 1	236 2	238 8

($00,000 omitted)

	1939	1938	1937	1936	1935
Oil					
Long-term bonds	55 4	221 0	147 9	24 0	5 0
Stocks	1 3	1 9	46 4	26 6	5 1
TOTAL	56 7	222 9	194 3	50.6	10 1
Rubber					
Long-term bonds		37 1	8	9.4	
Stock	2	2 5	8	11 2	2 0
TOTAL	.2	39 6	1 6	20 6	2 0
Land—Buildings					
Long-term bonds	4 5	6 3			
Stock	.1		.5		
TOTAL	4 6	6 3	.5		
Investment Trusts					
Long-term bonds	2 0	4 0		1 0	2.0
Stocks		.1		11 9	
TOTAL	2 0	4 1		12 9	2 0

NOTE Miscellaneous shipping, equipment manufacturers not included. Short-term notes also omitted as not important

There are three of these groups—iron, steel, and copper, other industrials and manufacturing, and oil—which have issued the greater part of these industrial securities—$2 2 billion out of a total of $2 7 billion in this class Of this total, $1 5 billion consisted of long-term bonds and $.6 billion of stock

We may conclude from these comparisons that the new capital pattern, as developed during the last five years, reverses the trend shown from 1926-29 The recent trend has been from stocks to bonds, the former trend was from bonds to stocks

Types and Purposes of Issue

Our final concern is an examination of the types and purposes of issue of securities marketed during the last ten years Recalling that the long-term capital market, like all other markets, is dominated by the influences of demand and supply, we have first to show the types of securities issued by the various classes of companies'—"industries"—and second, to explain how these security patterns were influenced by the financial

and industrial situation with which the managements of these industries had to deal

Railroad securities were mainly issued in the form of equipment trust obligations. A few large refunding issues, Louisville and Nashville and Great Northern, the two outstanding examples, were mortgage bonds issued with the same mortgage security as the bonds which they replaced The Reconstruction Finance Corporation, from 1932 to 1939, loaned $826,773,161 to railroads on whatever collateral or mortgage security these companies had to offer. Over half of these loans, $480,263,845, were unpaid in 1939. Most of these loans were made to avert default Most of them—the Pennsylvania Railroad electrification loans are an exception—were made because the usual financial channels were closed to the borrowers.

Public utility companies, including light and power and telephone, have used their existing mortgages, including large bond reserves, to borrow. The majority of these loans are secured by first mortgage When the borrowing companies are very strong, such as Commonwealth Edison and American Telephone and Telegraph, the last-mentioned with $160,000,000 of 30-year bonds sold to yield 3.13 per cent, debenture bonds have been sold By number, however, most of these bond issues have been secured by first mortgages.

To establish the trend of industrial security issues during this second period, 1930 to 1939, we have taken a very large sample, 276 companies, whose assets, in 1939, were stated as more than $10,000,000 each Railroads, in reference to the new capital market, are of little importance Utilities are, as stated above, limited, under present conditions, to first-mortgage bonds issued under set patterns of bond reserves. Financial companies—banks, investment trusts, insurance companies—are very quiet Real estate financing is dead. Industrial corporations, however, are very much alive. It is in the fields of manufacturing, mining, and retail distribution that profits are now made, plants and working capital expanded, and readjustments made. From our examination, we have excluded all companies reorganized since 1930, and companies of foreign origin (except a few Canadian companies), finance companies (except instalment finance), and security holding companies

To explore this matter further, we may divide these 276 companies which issued securities, between expanding and declining industries. Companies in *expanding industries*, generally speaking, need new capi-

tal, and as already shown, the assets of these companies, over a period, show substantial growth.

In the *declining industry* group, assets are shrinking, additions are not made, new capital is confined to betterments to reduce costs and improve quality. Such expenditures may be desirable if they do not involve an increase of debt. If, however, money is borrowed for betterment installations by a company whose sales and earnings are declining, the increase in overhead is likely to be embarrassing. And money is seldom borrowed for this purpose. Companies in declining industries are not attractive to stock buyers, and bond buyers, also, are not enthusiastic about them. Their day, as sources of investment income, is drawing to its close.

Our next inquiry concerns the purposes for which the new capitalization was issued. Here, again, the distinction between the purposes of expanding and declining industries is helpful. Expanding industries, generally speaking, always need money for new plant and equipment (additions), for replacements of outmoded machinery with new devices (betterments), and for additional working capital to handle increasing sales. These funds can be obtained out of profits, or by the sale of securities. The advantages and drawbacks of the two contrasting methods have been discussed in preceding chapters. If securities are sold, they can be either stock—common or preferred—and/or bonds and notes. The important considerations which govern management in these selections have been discussed. If the debt method is selected, the management must consider the form of debt, amount of debt in reference to income, provision for repayment, and interest rates as influenced by type, amount, and term. All of these matters have been reviewed and explained.

Declining industries, as explained above, do not need capital for any other purpose than betterments. Additions are not called for. Declining sales reduce working capital requirements. Only when management takes the bull by the horns and shifts to a new line which is expanding, and this shift is very difficult and often dangerous, can new money be profitably employed. Unless the shift is made before surplus earnings, the basis of new investment, are exhausted, while existing liquid resources are available, the declining company can not make the additions necessary to develop the new line.

Many companies, in both expanding and declining classes, have fixed interest and dividend securities outstanding. Bonds and notes have

maturity dates when they must be paid or replaced by new issues Both bonds and preferred stocks are subject to redemption at any time at premiums set out in the contract If interest or preferred dividends have been regularly paid, and if the condition of the capital market permits, new securities can be sold, calling for lower rates of preferred dividend or bond interest, and substantial savings can be made by these substitutions. As already shown, this opportunity for refunding has been offered to American corporations during the last six years

Keeping this fact in mind, let us examine first the forty-four cases where companies in declining industries have issued securities, to determine the purposes for which new money was raised The purposes for which the new securities were issued, divided by number of companies, were as follows

1.	Refunding and retirement of senior securities	27
2.	Refunding and new capital	9
3	New capital	8

The first two classes may be considered together. A refunding operation often provides a surplus of cash after the bonds or preferred stock have been adjusted To exchange $5,000,000 "4's" for an equal amount of "5's," saves $50,000 a year in interest The refunding issue can therefore be made $5,500,000 with annual interest charges of $220,000, taking care of the senior securities, reducing charges by $30,000, and adding $500,000 to cash funds, always acceptable In most of the cases, however, the new securities are confined to refunding. No new money is provided.

Only 5 out of 40 companies located in declining industries issued substantial amounts of securities for expansion Of these companies, Phelps Dodge, Cuneo Press, Cluett Peabody, and Safeway Stores are very strong because of certain differential advantages over their competitors They continue to improve their plants and increase their working capital Consolidated Film, the fifth in this group, sold stock in 1930, before the depression attacked the motion-picture industry which it serves.

In the expanding industry group, 232 companies sold securities The division by purpose of sale is as follows.

New capital	137
Refunding and new capital	42
Refunding alone	53

There is a marked difference between the two groups. In the declining industry group, only 17 issued securities to obtain new capital. Of this number, 9 companies obtained new capital for a minor part of the securities issued In the expanding industry group, 137 out of 232 provided money by the sale of securities without refunding. Forty-two companies, in their sale of securities, combined refunding with the provision of some new money. To the second group, since most of the proceeds of security sales by the members of this group went to the refunding of existing securities, in any representation of the division between the two objects of security sales, refunding and new capital, should be added the members of the third group whose securities were issued for refunding—53 In final division, 137 companies in the expanding industries sold securities for new capital exclusively, and 95 sold them to retire maturing or redeemable senior securities carrying interest or preferred dividends higher than those carried by the new securities issued to replace them. The distinction between the capital policies of declining and expanding industries (groups of companies) is again emphasized by this comparison. Both groups refunded senior securities and made large savings by so doing. The declining industry companies, as a class, do not sell securities to obtain new capital except as they may add something for this purpose to their refunding issues These companies have little use for capital. These additions to refunding issues are also found in the expanding companies, and, in addition, nearly 60 per cent of these expanding companies have sold stocks and bonds to increase their assets, while at the same time reserving substantial amounts of profits in the business.

We come now to the types of securities issued since 1930, or rather since 1935, leaving out the depression years when little financing or refinancing was done.

Of the bonds issued by companies in expanding industries, 45 issues are classed as secured bonds and 34 issues unsecured. These issues are generally closed Of the total number, 40 are for 15 years or less, 19 being for 15 years, and 20 for 25 years. Only one, and that was quickly refunded, was for 30 years. The term of the bond does not seem to affect the interest rates, since a large number of the 4-4½ per cent bonds were for 15 and 10 years All of these secured bonds are protected by sinking funds. The practice is to retire at least 30 per cent, and sometimes the entire issue before maturity Most of these bonds were issued to retire higher

interest-bearing obligations. In some cases, Bethlehem Steel and National Steel, for example, the issue of long-term bonds was accompanied by substantial, though smaller issues of short-term notes, usually serials, which have the advantage from the sellers' standpoint that they lower the combined interest payment. The short-term notes carry very low interest rates and are sold to banks. These split issues also make the long-term bond more attractive, since their amounts are reduced substantially below the amount of debt for which they are substituted The secured feature also makes them more attractive, although, as will be presently shown, this advantage is psychological and traditional, rather than factual The closed mortgage feature is also appealing to the buyer, although, since all bonds are callable, this presents no obstacle to later refunding if market conditions permit. Interest rates on these secured bonds as a class are substantially higher, a fact which will presently be demonstrated, than on the unsecured bonds which constitute the prevailing type of bond sold by companies in expanding industries It is impossible to escape the conclusion that there is a connection between the presence of supplementary contracts of security and the quality of the bonds offered These contracts do not make the bonds substantially better, but the investor believes that they do, and is more ready to buy them.

The favorite type of bond issued by companies operating in expanding industries is the debenture. The differences between these "plain" bonds and secured bonds has been already explained With proper restrictions on issue, as a practical matter of security to the creditor there is no difference between the two types The investor is as safe in holding a debenture as in holding a mortgage bond With the two classes of bonds issued by the same company, when default occurs and the company must be reorganized, the claims of secured bondholders must be satisfied first When only debentures are issued, or when mortgages following the issue of debentures must include these "plain" bonds, there is no difference between the two classes in point of security. It is difficult to emphasize too strongly, or to repeat too often that the security of any obligation is the earnings of the issuing company, that the only value of a mortgage or a collateral trust indenture is to establish priority in case of default. In recent years this fact has been generally recognized, and the most conservative institutional investors have abandoned their previous preference for secured bonds. It is true that the laws regulating

the investments of savings banks and trust funds still, generally speaking, confine their investments to first-mortgage bonds. Life insurance companies, however, are under no such restrictions, and they have bought freely of high-grade debentures Commercial banks, trust companies, and trustees, where the law did not forbid, have followed the lead of the insurance companies.

In the expanding industries, where the trend of earnings has been upward, 41 issues of secured bonds have been made during the last decade, as compared with 103 issues of debentures including 4 short-term issues sold to banks The large borrowers, such as the oil companies, have especially favored this type of security Mortgage bonds have, in most cases, been issued by second-grade, although prosperous, corporations A short list of debenture borrowers will support this statement

American Can	$10,000,000
American Tobacco	24,000,000
Atlantic Refining	25,000,000
Bethlehem Steel	83,000,000
Commercial Credit	65,000,000
Commercial Investment Trust	82,000,000
Consolidated Oil	75,000,000
Continental Oil	21,071,000
Crucible Steel	10,000,000
General Motors Acceptance	150,000,000
Firestone Tire and Rubber	50,000,000
Gulf Oil	50,000,000
Shell Union Oil	85,000,000
Socony-Vacuum Oil	125,000,000
Standard Oil of California	25,000,000
Standard Oil of New Jersey	190,000,000
Tide Water Associated Oil	40,000,000
Union Carbide and Carbon	40,000,000
United States Steel	75,000,000
	$1,225,071,000

These 19 companies have issued over one billion dollars of debenture bonds, and only one, Bethlehem Steel, has sold any mortgage

bonds. These bonds were, without exception, low-interest bonds These were sold without difficulty, many of them directly to institutional buyers without the intervention of investment bankers

The favorite terms of the bonds recently issued are 10 and 15 years. The favorite type is the straight bond with a sinking fund In fact, the sinking funds are so large as to make most of these debenture issues, serials. These characteristics of safety are found also in the secured bonds. This feature makes the bonds more attractive to institutional investors who dream of the return of higher interest rates, when much of this low-priced money will have returned to them for reinvestment at higher rates of return. As for the borrowing companies, while they could, in this sellers' market, secure lower sinking fund requirements and longer terms, just as they had no difficulty in security low rates, they raise no objections to the high rates of amortization In fact, many of them have anticipated the requirements of the sinking funds They have paid off their debt more rapidly than the contract required

It is in the interest rates that the effect of a large surplus of investment funds most clearly appears Of 79 debenture issues sold by expanding industry companies since 1935, the classification of interest rates is as follows: 45 carried coupons of less than 4 per cent, 33 paid 3 per cent Some of the large borrowers, Standard Oil of New Jersey, for example, have paid less than 3 per cent Serials, in peculiar request by banks, have been sold at 1 to 2 per cent interest.

In present-day practice, all bonds are sold at or near par The former practice of offering the investor a "bargain" in the form of a bond sold at 93 or 95 has been abandoned. Discounts, when offered, are now very small, seldom above 1½ per cent, and they are not often offered The varying quality of the bond is reflected in the coupon. Firestone Tire and Rubber borrows at 3½ per cent, Standard Oil of New Jersey at 2⅝ per cent, United States Rubber at 4¼ per cent.

Preferred stock is not so much used as formerly Only 19 issues are found among the expanding industry companies included in our sample. The stipulated dividend ranges from 2½ to 6. Most issues stipulate 4½ They are usually callable at a small premium, but the "sinking fund" which was a very qualified obligation easily evaded in time of need like many purely sales features, is not so much used The decline in the popularity of preferred stock is due to the higher cost of money in this form Banks can not buy preferred stock for traditional reasons, because

there is usually no difficulty in securing the approval of a bond issue which would outrank the preferred, and because investment laws usually exclude this type of security from the list of legal investments

The conversion feature, an almost universal characteristic of bonds and preferred stock during the late twenties, has declined in importance. Of the 103 debenture issues mentioned above, only 5 were made convertible

Common stock for new capital purposes is the favorite form of security issued. It is almost always offered to stockholders at attractive prices. Most of the offerings are underwritten to make sure of their success Here the practice has not changed. Some of the strongest companies—Sears Roebuck, Montgomery Ward, Continental Can, Macy, and Atlantic Refining are conspicuous examples—have used common stock to obtain new capital, and in a few cases to obtain funds for bond payment The new industries, aviation, for example, have sold common stock to obtain funds for expansion The investor avoids "unseasoned" industries and a new industry has little "security" to offer. Earnings are too small to finance the expansion which they justify. Hence the sale of large amounts of common stock by companies operating in pioneer industries is common practice

From this survey of recent capital issues, we have found no reason to change our often expressed conclusion that the popularity of borrowing is declining Bank borrowing, as a means of providing working capital, has almost disappeared. The banks have been forced into the long-term capital market Insurance companies, savings banks, and managers of trust funds are at their wits' end to employ their surplus funds. The pressure of this demand upon the companies which have included bonds in their capital structures, has forced down interest charges to the lowest levels in history Nothing like these diminished rates has ever been known The profits in trading on the equity are very large The temptation to borrow is very great. And in spite of these inducements to incur debt, only a limited number of companies in the expanding industries, where large profits can be made, have changed their capital-raising habits

The list of prosperous expanding corporations which could have issued bonds to finance their expansion programs, but have, up to 1940, resisted the temptation to borrow, is imposing. This point has been par-

tially developed in Chapters 17 and 31 It will do no harm to develop it further.

Here is a partial list of expanding industry companies whose capital structures are free from bonds

1939 Income after Tax Deductions

(0,000 omitted)

Allied Chemical and Dye	$21.04
American Chicle	3.83
American Home Products	4 20
American Smelting and Refining	13.06
Borg Warner	5.68
Columbian Carbon	2.86
Caterpillar Tractor	6 00
Chrysler	36 88
Coca-Cola	38.25
Colgate-Palmolive Peet	6 63
Du Pont	93 27
Dow Chemical	4.18
Diamond Match	3.47
Eastman Kodak	21 54
General Electric	41 24
General Motors	183.29
General Foods	15.11
Hercules Powder	5 32
International Harvester	8.48
International Nickel of Canada	36.85
Johns-Manville	4.16
Kennecott Copper	33.95
(S S.) Kresge	10 45
S. H. Kress	4 96
Kroger Grocery and Baking	5.51
Libbey-Owens Ford	8.06
Montgomery Ward	27.01
Monsanto Chemical	5.43
National Lead	5 78
Owens Illinois Glass	8 43

1939 INCOME AFTER TAX DEDUCTIONS—*Continued*

(0,000 omitted)

Parke Davis	9.25
J. C Penney	16.48
Pittsburgh Plate Glass	10 77
Procter and Gamble	25 40
Sears Roebuck	37.26
Timken Roller Bearing	7.29
Underwood Elliott Fisher	12 20
United Fruit	14 10
Westinghouse Electric and Manufacturing	13 85
Wm Wrigley	8.65
TOTAL	\$820 17

This is an imposing list of silent witnesses against the policy of borrowing These companies are all prosperous, all expanding, all in need of capital The bankers are eager to lend The profits on cheap money are large Every one of these companies, on the basis of the present capital pattern, could borrow at 3½ per cent for fifteen years Taking a six-to-one ratio of earnings to interest, which is conservative, the combined earnings of these companies for 1939 would support \$3,876,000,000 of bonds And yet these companies issued no bonds.

CHAPTER 35

CONSOLIDATION OF CORPORATIONS

Consolidation of corporations is a joining together under one corporate control of two or more separate and individual companies, uniting in this manner the capital facilities and consolidating their profits

The subject of consolidation of corporations is considered under the head of new capital, because consolidation is a favorite method of enlarging the scope of a company's operations and the amount of capital which it controls

Advantages of Consolidation

The principal advantages of consolidation are as follows,

1. The expansion of business without new construction
2. The reduction of operating expenses by increasing the volume of business which can be handled with a given amount of general expense, and the performance of necessary services for each member of the combination at lower cost than the members can perform these services, each for itself.
3. The control of markets by limiting the number of competing concerns.

These are benefits of consolidation as such—the gains from uniting two or more corporations under a single control

A manufacturing company may desire to buy the market for its product or the raw material of its product or an interest in the bank in which its funds are deposited, or the finance company which handles its instalment sales, or the steamship line or railroad which carries its products to market A railroad company may wish to control terminal facilities in a large city, or a connecting steamship line, or other railway lines which will shorten its hauls, reduce its operating expenses, or open new sources of traffic A city may have too many banks for the business offering, or too many restaurants or retail stores. In each case, consolidation is indicated

The advantages of consolidation must be distinguished from the advantages of big business. A business may grow to enormous size, as the Ford Motor Company has grown, without consolidation, by the investment of profits. On the other hand, the General Motors Corporation, the Irving-Columbia Trust Company, the United States Steel Corporation, the Consolidated Gas Company of New York, or the North American Company, are examples of consolidation where new companies are formed out of existing materials, or where, with an established company as a nucleus, other concerns are added to it, forming a much larger enterprise. Consolidation has played an important part in the growth of most large American companies. It is, in fact, exceptional to find a company of the first rank which has not grown, in part, by accretion.

The Remington Rand Company

We take up the second object, the expansion of business without new construction.

The Rand-Kardex Bureau, Incorporated, was the largest manufacturer and distributor of filing, record-keeping, and record-protecting devices. Its products included modern visible filing equipment, steel and wood filing cabinets, office furniture, indexing systems, safes and safe cabinets, guides, folders, and filing supplies. It had over 1,000,000 customers and its line included 4,000 items. The Rand-Kardex Company was a consolidation of four concerns in this line. The company desired further expansion into the production of calculating machines and typewriters, and also to eliminate the competition of a large company in its own line. Two methods were available to the Rand-Kardex Company, which was a prosperous and growing concern. It could develop a line of typewriters and calculating machines, marketing them through its own agencies, and pushing them into a market already crowded with these devices. It could also continue its competition with the Baker-Vawter Company, which specialized on loose-leaf accounting devices and supplies, cutting prices and engaging in several trade wars, the outcome of which would have been doubtful. If successful, the Rand-Kardex Company would have continued to grow, and, after perhaps many years, would have reached a position where its net earnings before federal taxes and interest would have amounted to $7,716,378, the combined earnings of the companies concerned.

The road to this goal, however, was steep, rough, and dangerous.

Price-cutting, loss of employees to enterprising competitors, patent litigation, duplication of agency and service facilities, duplication of advertising expense presented an uninviting prospect, especially since an easy road to the same goal lay open.

Absorption of Typewriter, Calculating Machine, and Filing Equipment Lines

Instead of developing a line of typewriters, the Rand-Kardex Company absorbed the Remington Typewriter Company, using a new corporation name, the Remington Rand Company, for the purpose The Remington Typewriter Company had a record of 53 years and possessed a complete line of standard, noiseless, electrical, tabulating, portable, and bookkeeping typewriters, sold through 1,000 sales offices. Instead of developing a line of calculating machines, the Remington Rand Company absorbed the Dalton Adding Machine Company, whose product includes over 150 models for practically every computing need of business, including adding and calculating machines, the direct subtractor and multiplex ledger posting and statement machines Finally, instead of continuing competition with the Baker-Vawter Company, the Remington Rand Company absorbed it also—thus attaining at one step, by the process of consolidation, a dominating position in the field of office appliances, absorbing an immense value in patents, several thousand experienced salesmen, and good-will representing the expenditure of many millions of dollars in advertising. Instead of increasing competition, competition was to some extent reduced Instead of building up departments, with all the incidental troubles—legal, mechanical, distributive—these departments were taken in, ready for operation.

Advantages of Horizontal Consolidation

The Remington Rand Company is an example of horizontal consolidation, the union of concerns which operate in either competing or complementary lines The advantages of horizontal consolidations lie in the increased size, which may result (1) in a reduction in overhead, (2) in modifying the rigors of competition, (3) in important economies in purchasing, and (4) in standardization of methods and equipment.

These advantages are illustrated by the large holding companies, which exert a dominating influence in the industrial field, and, so far as production is concerned, in the public utility field. These companies,

such as Associated Gas and Electric, North American Company, United Gas Improvement Company, Cities Service Company, and Northern States Power, group under one control large numbers of utilities operating both in large and small communities It is not going too far to state that the entire public utility business of the United States, outside a few of the large cities, either controls, or is controlled by, a few large holding companies

The Associated Gas and Electric Company

The scope of this control may be illustrated by the Associated Gas and Electric Company. The holdings of this company are mainly concentrated in three areas, eastern and western Pennsylvania, and western New York The scope of its influence, however, is constantly growing and has extended into Canada, South Carolina, Florida, and the Philippine Islands. Sixty of the more than 100 controlled companies are public utilities serving a population of over 4,000,000 in over 900 communities, located in 20 states and the Dominion of Canada. The company also controls a large production of oil and natural gas All of this large business, whose consolidated earnings in 1929 were $69,903,253, is controlled by the company which stands at the apex of the pyramid, Associated Gas and Electric We shall have later occasion to study the financial structure through which this control is exercised For the present, however, we are confined to an enumeration of the business advantages of this type of horizontal consolidation which serves, in general, to illustrate the advantages of all the others

Local, as Distinct from General, Functions

In the management of any number of companies operating in the same general field, two classes of functions may be distinguished First, those which are local to each community, e.g , in a gas or electric plant, the employment of labor, the day-to-day operation of the plant, the keeping of records, the collection of money, making new service installations, and routine dealing with public authorities These routine functions must be performed on the ground by each local manager for each local company, and the more the local manager is left to function on his own responsibility, untrammeled by directions from some distant central office and judged solely by results, the more successful will he be.

A second group of functions is common to all the concerns operating

in an industry, e.g., gas or electricity the engineering of betterments and additions, the handling of rate matters with public authorities, the construction of rate schedules, the cultivation of new business, the purchase of materials, and, of primary importance, the raising of money. These functions are far from routine, although, in time, they may become more or less standardized. They require, for their successful performance, a high order of ability for which only large companies can afford to pay, but which, when once secured by the central organization, can be placed at the disposal of a hundred plants, lowering operating costs, improving quality of product or service, and increasing each one of them.

Financial Service Performed for Subsidiaries

The first of these functions is finance. With the rapid growth of cities and towns, utility plants must be constantly and rapidly extended Limited earnings will not furnish the necessary funds, even if no dividends were paid and all profits put into extensions. For example, the Bell System in 1939 spent on new construction $314,925,000 and its total net income was $172,586,000, from which dividends and interest were paid. Constant additions of capital funds from the sale of securities are, therefore, necessary. These public utility companies may be divided into two classes, the large companies whose positions are so strong that they can easily obtain the required money at the minimum rates, and the companies serving towns and medium-sized cities, whose needs for expansion are relatively the same as the needs of the large companies, but which, because they are small and unknown, are forced to pay high rates for their money When these small companies are taken into a large holding group, such as the United Gas Improvement Company, the parent company makes such advances to its subsidiaries as are necessary, takes their bonds or stocks into its own treasury, and sells its own securities to the investor to obtain reimbursement of its advances When these subsidiaries are strong, the parent company may dispose of the securities directly to bankers or may use them as the basis of an issue of collateral trust bonds, or the parent company may sell its debenture bonds, keeping the securities received from the subsidiaries in return for advances, free in its treasury, available for use in case unsecured plain debentures can not be sold on as favorable terms as collateral trust bonds

In the difference between the cost of the money to the parent company, and what they can properly charge the subsidiaries, the holding companies find another opportunity for profit There is nothing unfair in this, as long as they lend money to their subsidiaries at lower rates than the subsidiaries could borrow for themselves A higher rate would, of course, be a ground for criticism and possible interference by the public authorities. It is not unreasonable to suppose that, so far as is legitimate and proper, of which the holding company officials are the judges, the affairs of the subsidiaries are conducted with a view to the profit of the holding company.

Technical Supervision Service

The second service performed by the utility holding company is the supplying of technical supervision. The holding company can afford to employ the best engineers and research men obtainable, whose services are at the disposal of every subsidiary no matter how small A service fee is usually charged for this work, which is an addition to the operating expenses of the subsidiary and which should be less than the price the subsidiary would pay if it employed these experts on its own account.

Purchasing, Public Relations, Central Power Supply, and Research Services

The parent company also functions in the purchase of supplies, materials, and machinery, obtaining these at prices below what a small company would be charged, and making substantial savings in their operating costs Some of these large organizations have gone into coal-mining on a large scale, operating so-called "captured" mines for the exclusive use of their own plants, whose costs of production, because of the steady calculable demand for their output, are below the costs of mines which sell in the open market, and whose operation, therefore, since it depends in fluctuating orders, is irregular and therefore more expensive Some of the advantages of these low costs are passed on to the subsidiaries, although there is no obligation on the part of the parent company to do this, since the subsidiaries could be made to pay the full market price.

In the field of public relations, the construction of rate schedules, and the marketing of the product or service, the superior service of the holding company is placed at the disposal of every subsidiary. Skilled

legal and marketing counsel, commanding salaries out of reach of a small company, are placed at its disposal by the central organization, and the cost to the subsidiary is small compared with the value of the service.

The central organization can function in other profitable ways. It can centralize its power generation into large power-houses, where current can be produced at low cost and distributed through many small companies serving a wide territory A recent development along the same line is the central gas plant, from which gas is distributed in the same manner as electric current.

Research work is expensive. It is coöperative in nature. The solution of any problem requires the work of a large research staff. The 1938 report of American Telephone and Telegraph referred to a large number of completed developments relating to elements of the complex communication plant, not apparent to the user The most noteworthy of these being the new crossbar system of machine switching. In the field of transmission broad band systems by which a large number of telephone channels can be provided over a single circuit are going into use Research work on the coaxial cable and in the field of radio telephone transmission has been pushed vigorously Every telephone company in the nation-wide Bell System has the advantage of all these discoveries and improvements.

Service Performed for Subsidiaries by Industrial Holding Companies

The utility holding company furnishes the best illustration of the economies of horizontal combination. The large industrial combinations, however, have not, on the whole, been as successful in realizing these economies as have the utilities. This is explained by the more rapid changes in methods and equipment, and the relatively small amount of monopoly power, compared with the nearly absolute monopoly of the utilities, which industrials enjoy. In certain lines, however, engineering and research, purchasing, dealing with railroads, and export trade, these large industrials have realized important advantages from centralized control of the activities of subsidiaries.

Horizontal consolidation is frequently met with in the field of distribution. Conspicuous examples are F W Woolworth, Sears Roebuck, Montgomery Ward, Kress, Kresge, Grant, Atlantic and Pacific, First

National Stores, Federated Department Stores, Walgreen, J. C. Penney, and many others These companies, as a class, are prosperous. The groups in which they are found—variety chains, food chains, mail-order chains, department-store chains, drug chains—may be classed as expanding industries These chains sometimes number thousands of stores. They sell at lower prices than competing "independent" stores, primarily because of their lower overhead expenses, superior buying power, mass advertising, and standardized methods of marketing. Because they sell at lower prices, they have grown to dominant positions in their several fields. They vigorously compete with each other and with the independent stores in their various lines. Aside from the danger of prohibitive chain-store taxes, now passing away, they promise large profits to their owners. They represent big business in its most useful and profitable form.

CHAPTER 36

METHODS OF CONSOLIDATION

The methods of uniting corporations by consolidation are three first, the merger, second, the purchase by one company of a controlling stock interest in another, third, the lease

The Merger

When a merger of corporations is accomplished, one or more of the companies concerned loses its identity in the consolidated company. Take the case of two gas companies—A and B—competing for the business of the same town. A sufficient amount of the stock of B has been acquired in the interest of A, to control the sale of its assets and its dissolution. Two methods are available for merging B with A. First, A may offer its stock or bonds or cash in exchange for the stock of B, having acquired the amount of stock which by the laws of the state or the charter of B is necessary to assent to the sale of B's assets. The directors of B now sell the property of that company to A If all the stock of B has been acquired, the consideration need be only nominal. A now controls all the stock of B, and secures the dissolution of B, in the manner provided by law. The second method is for A to purchase the property of B at its market value in securities or cash. B has then in its treasury the proceeds of the sale B is then dissolved and the directors distribute its assets to its stockholders

Objections to Merger

The method of merger is sometimes not available. There is often some advantage to a company acquiring control of another company, in continuing the corporate existence of its subsidiary. Companies which have been in existence long enough to establish a reputation have a good-will value in connection with their name, which would terminate if their corporate existence were ended. Valuable privileges may also be lost if the method of merger is adopted. For example, a gas company operating in a large city where a rate of $1 00 per thousand feet shows substantial

profit, may control various suburban gas companies whose rates, because of higher cost of operation, may be \$1.50 per thousand. A merger with these suburban companies would result in lowering their rates. Their corporate existence may, however, be maintained without merger, by the method of stock control, and the high rates continued. The salary accounts of the subsidiary companies are nominal, and the operation of their property can be merged, if desired, by leasing their property to the main company, or by operating them as divisions or departments of the parent company

This method of merger, the purchase of the assets instead of the stock of one company by another, is now universally used except in cases where an Ohio corporation is acquired by a Delaware company, for example, which must be incorporated under the laws of Ohio, i.e., an Ohio utility In addition to the tax reasons already cited, the Clayton Act provides in Section 7,

> That no corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital of another corporation engaged also in commerce, where the effect of such acquisition may be to substantially lessen competition between the corporation whose stock is so acquired and the corporation making the acquisition .
>
> This Section shall not apply to corporations purchasing such stock solely for investment and not using the same by voting or otherwise to bring about —the substantial lessening of competition

Under this provision of the federal law, a steel corporation engaged in interstate commerce may buy a controlling interest in a coal-mining or transportation company, or a cement company, or a company manufacturing oil-well equipment, but it may not buy a controlling stock interest in another steel company producing the same steel products. Vertical consolidation is not prohibited by the Clayton Act, but horizontal, involving the acquisition of control of competitors, is prohibited. Most consolidations involve the purchase of competitors. The Clayton Act prohibits the method of stock purchase

No prohibition is made in the Act of the purchase of assets of a competing company, and most mergers, therefore, take the second form The assets are paid for by stock, bonds, or cash. The consideration is paid to the former owner of these assets. The corporation formerly owning the assets is then dissolved, and the assets are distributed. Care must be taken by the purchasing company not to buy, directly or in-

directly, any stock of the company whose assets are to be purchased, although it is customary to assume the long-term debts of the company selling its assets as a part of the purchase price When such debts exist, the price received by the seller is the value of the assets, less the amount of the debt.

Illustration of Merger

An illustration of the method of merger is the absorption of the United States Sheet and Window Glass Company, in 1928, by the Libbey-Owens Sheet Glass Company The terms of purchase were as follows All the property and assets of the United States Company were sold to the Libbey-Owens Company Payment was made as follows $3,847,346 in cash, which was used to redeem the preferred stock of the United States Company, 9,188 shares of Libbey-Owens common stock, and 38,250 shares of United States common stock, belonging to the Libbey-Owens Company, or as an alternative to this United States stock, an additional 9,562 shares of the Libbey-Owens common stock All current liabilities of the United States Company were paid by the Libbey-Owens Company, except expenses, income taxes, if any, or other liabilities incurred by reason of the sale When its affairs were settled and the United States Company was dissolved, its common stockholders received, for each share, one-quarter share of Libbey-Owens stock. The option above referred to must, of course, be exercised, since, when the United States Company was dissolved, its common stock would have no value The method here indicated is that ordinarily followed the retirement of redeemable senior securities, the assumption of current liabilities, and the purchase of the merged company with the stock of the survivor.

In this case, and similar stipulations are usual in these offers, the offer was contingent on the assent of 85 per cent of the United States common stock. Non-assenting stockholders of this small amount can not block the merger, but have the right to their pro-rata share of the purchase price, the fairness of which can be ascertained by appraisal. Such appraisals, as a means of protecting the interest of non-assenting stockholders, are usually provided for by law.

Financial Moves Preliminary to Consolidation

It often happens, as a preliminary to any form of consolidation, and in order to make sure that a large majority of the stock of the company to be absorbed will vote in favor of the plan, that the owners or bankers

of the merging company will quietly or openly buy a controlling interest in the stock of the company which they desire to absorb. This is usually done when the stock is undervalued, so that there is no risk of loss if the merger does not go through. When, for example, the Kansas City Southern was proposing to form a consolidation with the Missouri-Kansas-Texas, and the St Louis and Southwestern, although there was no intention to end the corporate existence of the road last mentioned, the Kansas City Southern had purchased 250,000 shares of Missouri-Kansas-Texas common stock, a large amount of which was purchased in the open market. The Kansas City Southern also purchased 135,000 shares of preferred, and 20,000 shares of common of the St Louis and Southwestern. This stock was afterwards sold at cost to the Missouri-Kansas-Texas when the Interstate Commerce Commission refused to approve the proposed consolidation of the three companies, and instituted proceedings against the Kansas City Southern, alleging an unlawful combination in restraint of trade The Kansas City Southern, however, had already sold a large amount of this stock, and offered to sell the remainder as soon as market conditions permitted, so that the Commission finally withdrew its action Considerable profits were made on these sales.

When the method of preliminary stock purchase is not selected, the method followed, which may also be used when purchase of a control has been secured in advance, is to state the terms of the offer to all the stockholders, and to invite deposits of the stock with individuals or institutions, under an agreement by which each depositing stockholder authorizes the voting of his stock to carry out the proposed merger. Informal understandings with large stockholders usually precede such an offer. It is difficult to buy large amounts of stock in the open market Large purchasers whose designs can usually be forecast, are likely to run up the price to very high figures, which would reduce the profits to be realized by the merger If the necessary stock can be accumulated privately and so quietly, the minority will usually deposit the stock for exchange, making it unnecessary for the sponsor of the consolidation to go into the open market.

Consolidation by Stock Ownership

The second method of consolidation is that of stock ownership. One operating company can purchase the stock of another, giving in exchange

cash or securities, or a holding company can be organized for the purpose of holding the stocks of other companies which, by this device, are brought under centralized control.

Amount of Stock Necessary for Control

How much stock is it necessary for a company to acquire to control another? The rule of law is that, in the absence of a provision allowing stockholders to accumulate their votes on one or two directors, thus insuring to the minority representation on the board, a bare majority of the stock can elect, if the owners wish, all the directors. While the rights of the majority are seldom pushed to this extreme, the holders of a majority of the stock usually elect a majority of the board of directors. There is no general reason, therefore, for acquiring all the stock of a corporation in order to control it.

Necessity to Eliminate a Minority under Certain Conditions

However, where the interest of the parent company may be opposed to the interest of the subsidiary company, there is no alternative, if it is desired to maintain the identity of the subsidiary, save for the parent company to acquire all of its stock, or to see that its control is held in the parent company's interest Many of the consolidations of manufacturing concerns have resulted in the closing of badly located or otherwise unprofitable mills in order to concentrate the production in plants which are better equipped or better located. This policy makes for the interest of the parent company It is, however, opposed to the interests of minority stockholders of the corporations owning the plants whose operation is discontinued. If their businesses were to be closed up in this manner, these companies would be ruined. The minority stockholders would appeal to the courts which would give them protection against the depreciation in the value of their shares which would follow the suspension of dividends on their stocks.

Illustration of Threatened Exploitation of a Minority Stock Interest

An illustration of the possibilities of majority control by an adverse interest is furnished by the controversy between the Shell Oil Group, which owned a controlling interest in the V. O. C. Holding Company, Ltd., and the minority stockholders The Shell Company bought the crude-oil output of the V. O. C., which is the largest individual pro-

ducer of crude oil in the world. The minority committee charged the Shell Group with forcing V. O. C. into a contract which provided, among other things, for 36 cents a barrel for transporting its product from Lake Maracaibo to Curaçao and delivering it on board vessels, a compensation which the committee "is advised is grossly excessive." The minority also charged that the correct policy for their company is not to remain dependent on the willingness of the Shell to buy the crude oil, but that they should provide their own transportation and oil-refining facilities. They concluded with a quotation from the London *Times*, which sums up the dangers in such adverse control.

> The controversy really arises out of the present dual relationship of the Shell Company and the V. O. C The Shell Group holds the majority of the shares of the V. O. C, it manages the property, and acts both as buyer and seller of oil. So long as the present dual relationship exists, it will present frequent opportunities for criticism.

In the nature of such a case, it is impossible to preserve an even balance between the interests of controlling and of controlled companies Absorption of substantially all of the minority stock is the only way by which the majority can avoid the possible danger of a controversy with a minority interest This point was emphasized by the Interstate Commerce Commission in rejecting the Loree combination in the Southwest. The majority of the commission pointed out that control of a majority of stock of a railroad by a competitor constituted a very real danger. If the Kansas City Southern owns only little over half of the outstanding voting stock of the Missouri-Kansas-Texas, it would be greatly to its advantage to draw business away from the latter at all junction points It would gain far more in earnings from this divided traffic than it would lose in dividends To avoid such trouble, it is usual to secure all the stock of the company to be consolidated, in case this can be purchased at reasonable figures.

Guaranteed Dividend on Minority Stock

If all the stock can not be acquired, and in case the subsidiary company is to be used for the benefit of the interests which control it, rather than for its own benefit, a method which has been employed in many cases is to guarantee a dividend on the minority stock of the subsidiary. This plan was followed by the Carnegie Steel Company in 1901, in

guaranteeing 4 per cent on the minority stock of the Pittsburgh, Bessemer and Lake Erie Railroad Company, whose principal freight, since its organization in 1897, had been ore destined for the Carnegie furnaces. The minority stockholders of the railroad company complained that their failure to receive dividends was due to the fact that the owners of the majority of their stock—the Carnegie Steel Company—received such low rates on its ore that the railroad company was unable to make a profit In order to quiet this criticism, the Carnegie Steel Company, through a subsidiary company, the Bessemer and Lake Erie, guaranteed a dividend on the Pittsburgh, Bessemer and Lake Erie stock, leaving itself free to fix rates as low as it thought best

When May a Minority Stock Interest Control?

When the consolidation is for mutual benefit, there is no advantage in exploiting any member for the benefit of another, and the minority stockholders have no good reason to feel aggrieved by the acts of the controlling interest Moreover, where the stock of a company is widely scattered, a controlling interest may be much less than a majority The Pennsylvania Railroad Company for years exercised a potent influence in the directorates of the Baltimore and Ohio, the Chesapeake and Ohio, and the Norfolk and Western, and still controls the company last mentioned. At no time, however, did it own a majority of the stock of any of these companies, with the exception of the Norfolk and Western, for a short time. Any contest for control, however, during the period of the Pennsylvania's influence, would have been hopeless, owing to the control of the administrative machinery of these companies in the interest of their principal stockholder, and to the advantage which this control would have given these officers in soliciting voting proxies.

Speculative Holdings Figure in Stock Control

In further explanation of the ease of controlling large public companies, let us cite the fact, well known, but little regarded, that a large amount of such stock is frequently in brokers' offices as collateral for brokers' loans and standing in the brokers' names. Brokers depend upon banks to furnish them the money to carry on their business Banks are friendly with corporation directors and officers who direct the large deposits of the companies this way or that. Where these brokers' proxies are desired by the company, an intimation from the bank where the

broker carries his account that it would be a favor to them if the proxies were furnished is all that is required to produce them An individual stockholder or group of stockholders without these financial affiliations would have no chance to get these brokers' proxies. Under the rules of the New York Stock Exchange, brokers are required to advise the owners of the stocks held in their offices of the request for proxies and to request instruction If no instructions are furnished, the broker is free to vote the stock as he wishes.

Consideration Offered in Stock Purchase

Having settled upon the amount of stock required for control, how may this stock be acquired? Stock may be purchased for cash, or with the stock or bonds of the purchasing company, or with stock trust certificates on which dividends are guaranteed by the company acquiring the stock The consideration which will be offered and accepted in the sale of stock control can be viewed from the standpoint of the purchasing company, and also from the standpoint of the stockholders who sell their holdings A purchasing company, if its surplus over its regular disbursements is substantial, can safely offer bonds or their cash equivalent to holders of stock which it desires to purchase. Other things being equal, an offer of collateral trust bonds is especially desirable from the seller's standpoint. He receives a promise to pay, secured not only by the credit of the buyer, but by the stock sold. If interest is not paid, the stock can be recovered. If the purchaser is in a strong financial position, and if there is a prospect that the stock purchased will become more valuable in the hands of the purchaser, the method of purchase by bonds is likely to be adopted The stockholders who receive bonds for their holdings surrender all right to future shares in the profits of their company over the amount of interest on their bonds The purchasing company, by giving them a secured claim, succeeds to their right to share in profits over the amount paid in interest

In some cases these purchases of stock with bonds have proven immensely profitable. In 1898 the New York Central purchased $45,000,000 out of $50,000,000 of the capital stock of the Lake Shore and Michigan Southern, giving in exchange its 3½ per cent bonds at the rate of $200 in bonds for $100 in stock. The 7 per cent dividends on the Lake Shore stock represented the equivalent of the interest paid on the bonds issued in payment. From 1899 to 1903, the Lake Shore paid 7 per cent,

from 1904 to 1906, inclusive, 8 per cent, in 1907, 12 per cent, in 1908, 14 per cent, and in 1909, 12 per cent Later dividends were larger, until the Lake Shore was merged with the New York Central. The purchase of the Lake Shore stock proved most fortunate for the New York Central. There is the more reason to adopt the method of purchasing stock with the bonds of the purchaser, if the stock desired is a dividend payer, since then a substantial portion of the interest on the bonds can be provided out of the stock purchased

Preferred Stock Rather Than Bonds Frequently Offered

When any doubt exists, however, concerning the ability of the purchasing company to meet the interest on a sufficient bond issue to buy the stock which it desires, prudence demands that stock be used Cumulative preferred stock is the type of security usually employed. The failure to pay dividends on such stock does not work the bankruptcy of the issuing company The United States Rubber Company, in a circular to its stockholders, recommending the purchase of stock of the Rubber Goods Manufacturing Company, stated the argument against bonds and in favor of preferred stock as follows

> If no better means were provided, it might be advisable to make such purchase by the use of collateral trust notes, but it occurred to the management that rather than subject their stock to the prior fixed charges of such collateral trust notes, the stockholders might prefer to provide the means of purchase by an increased issue of stock, the preferred stock of the Rubber Goods Manufacturing Company to be acquired by an issue of new first preferred stock of the United States Company in amount equal to that of the Manufacturing Company, and with dividends limited to eight per cent annually

Even where bonds can safely be employed, the importance of preserving the credit of the purchasing company influences the use of stock to acquire other stock The issue of bonds to that extent exhausts the credit of the buying corporation. If stock can be used as the means of purchase, the company's borrowing power is not weakened.

Considerations Influencing the Demand for Senior Securities in Stock Purchase

From the standpoint of the stockholder, the acceptance of an offer for his stock may be influenced by various considerations If he is not satisfied with the prospects of his own investment, there is little trouble

in inducing him to accept a fair offer. For example, at the time of the formation of the United States Steel Corporation, based on the Carnegie Steel Company, the Carnegie Steel Company threatened with its competition every one of the large industrials whose stockholders were asked to exchange their holdings for United States Steel stock. The necessity of averting this peril, and the advantage of an alliance with the strong Carnegie Steel Company produced practically unanimous acceptance of the offer of the United States Steel Corporation to the stockholders of the separate companies The Carnegie Steel Company stockholders, not only because of the great earning power of their properties, but because the consolidation could not be formed without them, demanded and received much better terms than those offered to the stockholders of other members of the consolidation. Mr. Andrew Carnegie, in particular, the majority holder, received all of the first-mortgage bonds of the United States Steel Corporation, about $300,000,000, for his holdings, an excellent illustration of a high nuisance value.

Basis of Allotment in Exchange of Stock

While there is always a trading element in fixing the shares of the stock of a consolidation which are allotted to the companies taken in, the basis of allotment is the value of each to the new company In the consolidation of the Abitibi Power and Paper Company, Ltd , of Canada, for example, with certain smaller companies in 1927, which was accomplished by the exchange of stock of the Abitibi Company, the basis of exchange was as follows Spanish River Pulp and Paper Mills, two shares of Abitibi stock for each share of common, Ft William Power Company, one share, Manitoba Paper Company, 18/25 of one share, St Anne Paper Company, 9/10 of one share, Murray Bay Paper Company, ½ share. President Alexander Smith, in a letter to the stockholders of the Abitibi Company, explains the method of valuation as follows

> In arriving at the basis of exchange as recommended, due consideration has been given to all pertinent facts having any bearing on the present and future values of the constituent equities. All companies have been ably represented and every divergent opinion has been fully discussed with a view to complete fairness to all shareholders On account of the diversity of conditions in each company, it has been impossible to arrive at any mathematical basis, or to find a common denominator to which the calculations might be reduced.

It was therefore necessary to determine as accurately as possible the unquestioned value of the shares of a united company, and the division of these shares among the shareholders of the constituents on the basis of the value each company is fairly contributing to the whole Financial condition, capitalization, earnings, history, location, equipment, wood reserves, abilities and disabilities past, present and future, have all been discussed and considered in arriving at the final result

It is usually impossible, as Mr Smith shows here, to arrive at any formula by which to determine the amount of stock in a consolidated company which is allotted to each company absorbed. The test is not what each company is worth as an independent entity to its stockholders, but what it is worth to the consolidation A paper company, for example, may have shown no earnings. It may have been operating at a loss for several years and its balance sheet may show a large deficit On the basis of a comparison of balance sheet figures, such a company may have but a small value At the same time, paper companies need large wood reserves, and the unsuccessful company may have such reserves. If its stockholders are well represented in the negotiations, they may receive a value in the new stock, far out of line with the figures shown in their reports, but a reasonable value when the advantage of their large lumber holdings to the consolidation is taken into account Instances are numerous where companies have been taken into consolidations at figures based primarily on the ability of their executives Ajax Rubber and Chrysler-Dodge are cases in point Another important consideration is the financial condition of the various companies If a company, otherwise desirable, has a large amount of senior securities, bonds, and notes, or even preferred stock, which it is necessary to clear away by payment in cash, the amount of consolidated company stock, which can be allotted in this case, may be considerably reduced. In bank consolidations, where the assets consist mainly of money, or money's worth in commercial paper, or securities whose value can be accurately determined, the method of a share in a common denominator for each member of the consolidation can be more closely followed, and there is less occasion to estimate and approximate.

Dangers to Stockholders Who Accept Stock in a New Company

Consolidation, from the standpoint of a stockholder of the constituent companies, usually involves an element of risk and uncertainty which

must be taken account of in fixing the terms of exchange. His present position is known to him He may be receiving high dividends and a salary as well If the consolidation is not successful, he may lose his dividend, and his salary, although important stockholding officials are usually taken over, may not be permanent This attitude of mind represents an obstacle which must be overcome among other methods by the terms of the offer It also influences, in many cases, the form of the consideration

Instances are not lacking where stockholders have given up dividend-paying stock in return for stock which paid them nothing A case in point is that of the Atlantic Transport Company, whose stockholders went into the International Mercantile Marine Company, exchanging their stock, on which they had been receiving regular dividends, for the stock of a large company on which they received nothing for many years. With a weak company or a new company offering to purchase, and especially when a corporation is organized for the sole purpose of acquiring the stocks of other companies, unless there are strong reasons urging consolidation, and unless bonds are not available, an offer of common stock will not, as a rule, prove attractive The holders of the desired stock demand either collateral trust bonds secured by the stock purchased, and with the provision in the indenture that in case of default the bonds can be employed to purchase the stock, or they demand cumulative preferred stock bearing a high rate of dividend An additional bonus of common stock is usually demanded by stockholders of strong companies.

Cash or Stock Frequently Offered

With an active stock market and excellent business prospects for the new company, this hesitation of stockholders to exchange dividend-paying stock for other stock is overcome by a cash offer for their shares.

In the numerous recapitalization plans which the abundance of capital since the war has produced, the consideration has been cash to the owners, transfer of control to the bankers, and a prompt resale to the public. Dodge Brothers, National Cash Register, and Victor Talking Machine are examples.

This cash offer may be accompanied by an alternative offer in securities. It has been said that "mankind dearly loves an option." Just as a bank depositor, if he is sure of obtaining his money on demand, does not

want it, so a stockholder offered a choice of cash or securities of a new company is far more likely to accept the offer of securities, than if he did not have a choice between securities and cash The underwriting syndicate may be very helpful in such a situation, by offering to provide the cash for those stockholders who prefer it. With responsible bankers ready and apparently anxious to step into their shoes, doubting stockholders are more strongly inclined to sell for the securities which these underwriters stand ready to take. A notable example was the purchase by the Great Northern and the Northern Pacific, of the Chicago, Burlington & Quincy

The official circular announcing the joint offer of the Great Northern and the Northern Pacific to purchase the stock of the Chicago, Burlington & Quincy stated that "The purchasers will pay cash instead of bonds to an amount not exceeding in the aggregate $50,000,000 to those shareholders who shall prefer to receive payment partly in cash, and J. P. Morgan & Company, as managers of a syndicate, have undertaken to provide such cash, and to take therefor such bonds at par and accrued interest You are accordingly offered the privilege of selling your stock at $200 per share, payable wholly in the 4 per cents described above, or in bonds to the amount of $160 and cash to the amount of $40." Here there could be no question that the bonds were worth 80 to the Burlington stockholders, and nearly all of them, partly as a result of the syndicate offer, elected to take the bonds in full payment

The Stock Trust Certificate

As a compromise between the stock and the bond, a company purchasing stock may employ the stock trust certificate. For example, the Minneapolis, St. Paul & Sault Ste Marie Railroad Company acquired most of the preferred stock of the Wisconsin Central with its leased line stock certificates secured by a deposit of the stock purchased, on which 4 per cent is guaranteed for ninety-nine years. These stock certificates do not differ essentially from a collateral trust bond In case of default, the holders of the certificates receive back the stock from the trustee and can sue for unpaid dividends. The obligation of the certificate is, however, a contingent and not a direct obligation, and on that account is more acceptable to the stockholders of the purchasing company.

CHAPTER 37

THE LEASE

The lease has already been defined as a contract by which possession of certain property is transferred from the owner, known as the lessor, to some other person or corporation, known as the lessee, the title to the property remaining in the lessor, but the possession and use vesting in the lessee under conditions set forth in the lease.

Provisions of the Lease

Corporate leases contain provisions covering the following points·

First, a description of the property, usually in the form of a complete inventory, which must be kept up to date, since the nature of corporate property is likely to be constantly changing For example, the property of a street-railway company, where the motive power is in turn changed from horse-power to cable, then to the overhead trolley, and finally to the underground trolley, may be entirely different at the end of a ten-year period from what it was at the beginning. If this property is to be leased to another company, it is important that the inventory be revised at regular intervals.

Second, the length of the lease It is usual to make corporate leases for long terms, ninety-nine years being common, and 999 years not unusual. When leases are made for shorter periods, options of renewal on certain terms are usually inserted

Third, payments under the lease. Corporate leases usually provide that taxes, insurance, interest, and expenses of maintaining the corporate organization of the lessor shall be paid by the lessee. In addition, the payment for the lease to the lessor is usually made in the form of a dividend upon the capital stock of the lessor as then outstanding. It may also be provided that the lessee shall pay as rental for the property a certain proportionate part of the gross earnings or of the net earnings This method places no limit to the participation of the owner in the profits of the property. These payments are frequently made on a slid-

ing scale so as to permit the stockholders to share in the expected increase in profits

Special Forms of Leases

Rentals under mining leases are usually fixed on the basis of the tonnage extracted, either as a percentage of the gross receipts, or at a fixed rate per ton. It is usual to stipulate for the payment of rental on a certain number of tons, whether or not this number is extracted. Oil leases generally account to the land-owner for the value of one-eighth of the output.

Leases to building corporations have been extensively used in the Middle West in connection with Land Trust Certificates Under this plan, central real estate is transferred to a trustee who issues certificates of beneficial interest in the property These certificates are sold to investors. The trustee then leases the property to a building corporation for a long term of years at a fixed rental sufficient to net 5½ per cent, free of all taxes including normal income tax The lease contains the option to purchase the certificates at a price to yield a profit to the certificate holders, and a sinking fund may also be maintained as a deduction from the net earnings of the lessee

Provisions for Maintenance of Leased Property

Corporate leases provide in great detail for the maintenance of the property This point needs to be more carefully guarded in short-term leases than when, for example, ninety-nine-year leases are made If the maintenance of leased property is not carefully looked after, as the date when the lease expires approaches, the lessee, unless he expects to renew the lease, will allow the property to deteriorate, making as much money as possible during the last year or two of his occupancy In order to protect the lessor against such an abuse of his rights by the lessee, there is usually reserved to the lessor the privilege of examining its physical condition A typical provision for maintenance is the following, taken from the lease of the property of the Manhattan Railway Company to the Interborough Rapid Transit Company

The lessee covenants and agrees, at its own proper cost and expense, to maintain, operate and run the demised railroads and property during the said term in the same manner as the lessor is now or shall at any time hereafter

be required or authorized by law to do, and shall and will keep all insurable property insured in reasonable amounts and rebuild all buildings and replace all property destroyed or deteriorated by fire or otherwise, to such an extent as to be unfit for use, and shall and will maintain, preserve and keep the railways and property hereby demised, including all property hereafter acquired, and every part thereof, in thorough repair, working order, and safe and efficient condition, and supplied with rolling stock and equipment, so that the business of the said demised railways shall be preserved, encouraged and developed, the business thereof be done with safety and expedition, the public be accommodated in respect thereto, with all practicable convenience and facilities, and the future growth of such business as the same may arise or be reasonably anticipated be fully provided for and secured.

The lessee further covenants and agrees, at the expiration or termination of this lease for any cause, to return and deliver the said railroad and railroads, real estate, and properties by this lease demised, including, among other things, all property, additions, improvements, and equipments which shall be furnished, constructed, or completed out of the proceeds of sale of the stock, bonds, or property of the lessor, to the lessor in as good order, condition, and repair as they were at the date this lease takes effect, or at the date when the same came into the possession of the lessee, and to surrender said franchises, rights and privileges, easements and properties unimpaired by any act of the lessee, excepting, however, all property of the lessor sold pursuant to the terms thereof, the proceeds of which shall have been applied as herein provided.

The lessee further covenants and agrees that it will, at all times during the continuance of this lease, at its own expense, keep the said rolling stock, and tools, equipment, machinery and implements necessary for the operation of the road, in good order, condition and repair, and will, as the same shall be worn out and rendered unserviceable, replace the same at its own expense, so that the said railroad and railroads shall always be kept, maintained and equipped in good and safe condition and effective working order

The lessee further covenants and agrees that it will at all times during the continuance of this lease, at its own expense, comply with all lawful requirements with respect to the construction, maintenance and operation of said railroads, extensions, or branches thereof.

Disposition of Proceeds of Leased Property Sold

In corporate leases, when the instrument covers, for example, a large and complex street-railway system, it frequently happens that some portion of the property of the lessor is no longer of use to the lessee It is for the interest of both parties that this property should be sold. Provi-

sion is usually made, therefore, for the sale of such property, with or without the consent of the lessor, but invariably with the stipulation that the proceeds of the sale are to be invested in improvements upon the lessor's property In other respects the language and form of a corporate lease closely follows the corporate mortgage, the main objects being to preserve the physical condition of the property and to protect the lessor against any claims or charges arising from the breach of any obligation connected with the property released. If the property is mortgaged, such a stipulation is, of course, necessary, and the consent of the trustee of the mortgage must be obtained.

Advantages to Stockholders of Lessor Company

A proposition made by a strong company to stockholders of another corporation to lease their property at a rental corresponding to the dividends which they are then receiving is very attractive, and it is not so essential to make sure of their acceptance by purchasing enough stock to control the board of directors of the lessor company, as when a proposition is made to purchase the stock. A typical proposition of this character is indicated in the following offer

> The Indianapolis Terminal and Traction Company offers to lease the property of the Indianapolis Street Railway Company, guaranteeing the payment of interest, taxes, etc , and also dividends on the street railway stock of one per cent on January 1, next, and thereafter semiannually 3 per cent for the first year, 4 per cent for the second year, 5 per cent for the third year, and from July, 1908, 6 per cent The term of the lease is for thirty years, which is the unexpired life of the Indianapolis Company's franchise from the city.

Advantages to Lessee Company

The advantages of the lease, from the standpoint of the lessee, are equally evident. The lessee company obtains the control of property without the outlay of any money, and usually on terms which leaves it a margin of profit after making the payments required by the lease. If property is to be built, a large amount of financing is necessary. Bonds or stock must be sold, and extensive construction operations entered into. If, however, the property desired can be rented from its owners, the lessee company comes immediately into the possession of a completed property, manned by an operating organization and on a profitable basis

The same result, from the standpoint of control, may be reached by purchase of the stock of the company owning the desired property, which can be pledged under an issue of collateral trust bonds. Here, however, the question of financing arises. The bonds must be sold, or a sufficient sale must be insured by a syndicate to purchase the amount of stock desired The purchase of stock control, moreover, may require the entire issue of the company which owns the desired property, and the financing may be extensive. To acquire control by the method of lease, however, involves no more than dealing with the board of directors, and the submission by them of a proposition to the stockholders, for approval by the percentage of stock fixed by law in the charter If the offer is advantageous, and with the prestige of the directors behind it, it is likely to be accepted without serious opposition.

Disadvantages of Lease from Standpoint of New Capital Provisions

Leased property has objections from the point of view of the lessee It is not available as security for loans to pay for improvements which may increase its value. While the property of a street-railway system is in the hands of the lessee company, and while its operation is controlled by the lessee, title to the property remains in the lessor In the natural course of improvement, with a steady growth of population, large extensions and additions and a large amount of reconstruction of the property are certain The progress of invention has completely revolutionized the methods and mechanism of street-railway corporations The motive power, types of cars, the methods of generating power, and the types of track, have been greatly improved. The cost of all these improvements and extensions which are made upon the property of the lessor, in the absence of special provisions in the lease, must be borne by the lessee company. With a short-term lease, the improvement of the lessor's property may be the ground for a successful demand for higher rental from the lessee, and improvements are likely to be deferred or abandoned on this account With a long-term lease, the only objection to improving the lessor's property is the difficulty of financing the cost of these improvements In such cases, the only property right held by the lessee is his leasehold interest obtained by capitalizing the profits of the lease This right may in some cases be very valuable The method of financing on the basis of leasehold value has already been explained and illustrated Where the profits on a lease are not large enough to make the

leasehold interest of great value, much difficulty may be experienced in financing improvements which are essential to the development of the system and which may, in fact, be demanded by the public authorities

Philadelphia Rapid Transit Company Shows Capital Difficulties of Lease

An illustration of the difficulty experienced by the lessee company under these circumstances was furnished by the Philadelphia Rapid Transit Company which held under lease the street-railway property of the Union Traction Company which preceded it in control of the street-railway system of Philadelphia. In September, 1908, the Rapid Transit Company sent a letter to the shareholders of the Union Traction Company as follows

On July 1, 1902, you turned over to this company your property on a rental basis You had acquired this property seven years before, had expended your money in the development of it, and while in later years you had shown a surplus from operation, that surplus had not, up to that time, been sufficient to justify the payment of a dividend.

This company, by the terms of the lease, undertook to pay you a dividend from the start, equal to the largest earnings which you had shown up to that time, and increasing until they should reach, as they now have, double that amount. In the past six years we have spent approximately $20,000,000 in building the new elevated and subway railway and $20,000,000 upon improvements and extensions of the system which you turned over to us This company has been subject to severe criticism for having assumed to pay a dividend upon the par value of your stock, only thirty-five per cent of which has been paid in, but the answer is that we have (in effect) spent upon this system not only the 19½ millions remaining unpaid upon your capital stock, but 10½ millions additional, with respect to which $30,000,000 no fixed charge has been assumed and no return has been paid.

The increased cost of operation, the recent depression in business and unavoidable delays in the completion of the subway have necessarily upset, to a certain extent, the calculations upon which the rental obligations were based. These conditions however, have merely postponed the fulfillment of our expectations, and the management has full confidence in its ability to place the property upon a substantial paying basis, provided it is able to do the financing always necessary for a growing property

Since we took over this property we have secured a contract with the city in which the Rapid Transit Company has given up valuable privileges for the purpose of securing to your company immunity from the threat of hostile

> legislation. This contract is of the very greatest benefit to the Union Traction Company and its underlying lines.
>
> As already stated, nearly half of the $40,000,000 capital raised by this company has been expended directly upon the surface system. Several millions of dollars went to the building of what are practically new lines, although they have been built under extensions of your old charters.
>
> The Rapid Transit Company has now made the final call upon its capital stock and this has been practically exhausted by the expenditures already detailed. It is now necessary to relay many miles of surface track and to add equipment of a more modern character calculated to serve the public better, and to collect a much greater percentage of the fares. These expenditures will be made directly upon your property, rendering the security of your lease that much better, both as to the value of the property and its earning power.

It appears from this letter that, unless the Rapid Transit Company could make use of the credit of the Union Traction Company, the financing of necessary improvements would be impossible. A proposition was, therefore, made to the stockholders of the Union Traction Company to permit the former to use a large number of valuable securities enumerated in the list and entrusted to the Rapid Transit Company as collateral security for an issue of $5,000,000 of collateral trust bonds. The proposition was accepted by the Union Traction Company, and the funds provided. Evidently, however, the lessee company cannot always count upon the acquiescence of stockholders of lessor companies in placing encumbrances upon their property for the benefit of that property. In recent leases, provisions have been inserted whereby the lessor company is obliged, under certain conditions, to finance improvements upon its own property.

Foregoing Objections Removed by Boston Elevated Company

One of the most carefully drawn leases ever executed is that which gave to the Boston Elevated Railway Company the control of the property of the West End Street Railway Company.[1] The lease bound the Boston Elevated to pay 7 per cent per annum on the common and 8 per cent on the preferred stock directly to the stockholders without any reduction, the lease stating that these dividends were to be "net"

[1] Boston Elevated and West End Street Railway consolidated June 10, 1922, under terms of an Act passed by Massachusetts Legislature.

amounts. The lease further explicitly provided that the Elevated Company should pay all damages to persons or property, all sums due for taxes—Federal, state, or municipal—upon the lessor's property, franchise, or capital stock, and all sums "by law required to be deducted from any amounts payable upon the lessor's stock" The lease, on the other hand, stipulated that all saving from refunding of the West End Company's bonds should accrue to the lessee, the Boston Elevated Company. The lessee also assumed definitely the interest on the bonds of the West End Company, and on the existing indebtedness of any street railway which the West End Company was under obligations to pay. It also assumed all liabilities under the contract with the city of Boston, touching the subway.

The provisions in this lease regarding the right of the lessee to issue stock or bonds of the West End Company for improvements, particularly deserve attention. The West End Company was required to issue stock or bonds, from time to time, at the request of the lessee, in order to meet the cost of improvements and additions to the lessor's property The West End Company must be informed of the purposes for which it is proposed to issue the securities, and if it dissents from the expediency of the expenditure, and withholds its consent to the issue, a board of arbitrators must pass upon the matter If the arbitrators, by a majority opinion, do not approve the same, the lessee can not insist upon the issue being made One arbitrator is to be chosen by each of the parties to the lease, and the third by the two so chosen, or by the State Board of Railroad Commissioners, or by the Chief Justice of the Supreme Court of Massachusetts The lessee company has the right to decide whether the issue of security by the lessor shall be stock or bonds, and it may fix the rate of interest which the bonds shall bear, but it is provided that "no bond shall be issued in excess of the outstanding capital stock" of the lessor. Provision must, of course, be made, in case bonds are issued by the lessor for the improvement of leased property, for an increase in the rental to provide for interest and sinking fund on the new bonds

In order to protect the lessor company against improper use of its credit by the lessee, there is set down in detail in the lease the expenditures which the lessee can capitalize for the account of the West End Street Railway. These are especially limited to the following permanent additions and improvements

1. The abolition of grade-crossings.
2. Additional rolling stock and equipment
3. Additional track mileage and its equipment.
4. Additional real estate.
5. Additional stations, power, and car houses
6. Additional buildings, bridges, and other structures.
7. Renewals of, or substitutes for, stations, bridges, buildings and other structures, track, and equipment, "so far as the cost of such renewals and substitutes exceeds the cost, when new, of the things received or the things replaced."

Lessee Corporation, in Assuming Debt, May Take Over Bond Reserves

The provision just described is now often included in leases of properties where it is necessary to provide for capital expenditures. Another method sometimes employed, and which a proper organization of the capital account makes possible, is for the lessee, when it takes over the property of the lessor and assumes the obligation to pay interest on its bonds, to take over also any unissued bonds authorized under existing mortgages, and to issue these at will, subject to the restrictions of the mortgage This method is preferable to that employed in the Boston lease which is apt to lead to endless discussions and bickering over the propriety of particular expenditures. If the restrictions in the mortgage are carefully drawn, the lessee can, without danger to the lessor's property, and in fact with great benefit to the lessor, freely employ the credit arranged for in the mortgage for the benefit of the lessor's property. In this manner provision can be made for the expansion of the business carried on by the use of the leased property.

CHAPTER 38

THE HOLDING COMPANY

The holding company is a corporation organized for the purpose of acquiring the stocks and other securities of other corporations These securities are acquired, either by direct exchange of its own stocks and bonds, or by their sale for cash which is used to purchase the securities desired The ownership of the stocks of various companies gives the holding company the right to elect their boards of directors and to dominate their policy, thus accomplishing a combination between them which is as perfect, aside from the infrequent interference by an unrepresented minority and the cost of maintaining the corporate organization of the constituent companies, as though the different corporations had merged their existence in that of the company which has acquired a controlling interest in their stocks

Reasons for Use of Holding Companies

Holding companies are formed both for legal and financial reasons. The primary purpose of forming a holding company is to effect a combination of allied enterprises which cannot be accomplished by the use of any one of the corporations which it is intended to include. If corporations are organized under the laws of different states, there is no method by which they can be directly consolidated. Important considerations of financial expediency favor the use of this device when it is desired to bring under single control within a short time a number of properties in the same line of business When it is desired to form a combination, for example, of a number of steel manufacturing concerns, one of the operating companies can be used as a holding company, or a new company can be formed Even if no legal obstacles intervened, however, the holding company will be the device usually selected

The situation as regards consolidations may be summarized as follows

> The purpose of a holding company is the combination of allied and often competing enterprises Such a combination could be effected by any one person

or group of persons with sufficient capital It could be effected by the purchase outright of the various properties or business. Practically, however, many combinations would never be brought about except for the holding company Nearly all of the great consolidations, such as the United States Steel Company, the National Lead Company, and the International Harvester Company, have been holding companies It would have been impossible for the United States Steel Corporation to have been formed in any other way It is necessary in the getting together of such a group of properties to act quickly and at a favorable time It is necessary to get along with the minimum amount of cash The amount of cash necessary to buy the properties consolidated into the United States Steel Corporation would have been impracticable to raise It is necessary, further, as much as possible to retain the interest of a large number of stockholders in the older companies in the new consolidated company. It is necessary to provide a practical working method of bringing them all together, and particularly necessary to provide for the contingency that it may be impossible or impracticable actually to sell the property of one of these corporations to the consolidated company, or it may be impossible to get the consent of certain of those interested in the selling company to the consolidation.

Most of the stockholders will follow the lead of the directors, and if the details of carrying the plan through are so arranged that the stock in the new company has an apparent money value greater than the stock of the old company for which it is offered, the exchange, once started, takes place generally, and when a majority of the stock in the companies is exchanged practically the consolidation is effected. The difficulty in bringing enterprises together in any other way can be realized when you appreciate that in many states it is impossible for a corporation, even a private manufacturing corporation, to sell out its entire property, including franchises and good-will. It has been held in some jurisdictions that such a sale is foreign to the whole purpose for which the corporation was formed and that when the time for such a sale comes, it means the dissolution of the corporation and a final disposition of its assets among its stockholders There is further in certain states the absolute prohibition for a corporation of greater than a limited amount of capital to do business in the state. This alone would prevent the amalgamation of a number of properties into one great corporation directly owning all the properties [1]

Another reason for choosing the holding company for the consolidation is that to employ an operating company as the purchaser of the stocks of other corporations would require a large increase in the stock of

[1] Condensed from one of the first group of lectures on Finance in the Harvard Graduate School of Business Administration, delivered by Robert F Herrick

that company, and this increase might, under the laws of the state or the charter of the corporation, require the consent of three-fourths or even a larger proportion of the stock. Stockholders of the proposed holding company might object to this reorganization of the capital account for a purpose of which they might not approve, and the combination might be halted at its outset by embarrassing litigation resulting from the efforts of minority stockholders to protect their rights—whatever the motives back of the litigation

The Holding Company as a Finance Company

A holding company has various other uses in addition to that of accomplishing a combination It has been largely employed as a finance company. One of the best illustrations of holding companies organized for this purpose is furnished by the corporations manufacturing electrical apparatus and appliances. The products of the General Electric Company, for example, are purchased by corporations engaged in the operation of electric railroads, power, and lighting companies. When these companies are started, their promoters usually welcome assistance in providing the funds for construction. They are willing not merely to make liberal arrangements in the way of stock bonuses, but also to give to the construction companies affiliated with the banking or financial concerns which give them assistance in putting through their project, exclusive contracts, not merely for construction, but also for all materials and appliances which may be needed, for a long time to come, in the maintenance and extension of the plant.

The companies manufacturing electrical appliances, therefore, placed themselves in a position to render financial assistance to new companies in order to secure a market for their machinery The General Electric Company owned the entire capital stocks of the Electrical Securities Corporation and the Electric Bond and Share Company. Both of these companies were finance companies, they took part in the underwriting of securities of electric companies of various kinds, and also purchased the bonds of such companies, sometimes taking with the bonds a bonus of stock

They obtained the funds for these purchases, not merely because of the high credit which the backing of the General Electric Company gave them, but, also, by the sale of their own bonds secured by the stocks and bonds which they purchased. When a favorable opportunity occurred,

the collateral supporting these bonds was withdrawn and sold, a corresponding amount of the collateral trust bonds being paid off In other cases, the substitution of collateral, according to the method already explained in the discussion of the collateral trust bond, is permitted.

By pledging the bonds which it purchases as collateral for loans, a corporation of this character is able to free its capital for new employment without selling unseasoned bonds, which have no established earning power, at the low prices which such securities bring The bonds can be put away under the collateral trust mortgage until the companies issuing them have reached an assured position, when they can be sold at a substantial advance over the price paid. Bonds purchased by such corporations, moreover, often carry a bonus of stock, and the stock can either be held for dividends or sold as soon as it reaches a proper figure

The original object of the Electrical Securities Corporation and the Bond and Share Company was to assist the owner of their stock—the General Electric Company—in pushing its business It was not their object to retain permanently the bonds which they purchased As fast as these showed a substantial profit, they were sold and the proceeds reinvested in other securities

Recent History of the Electric Bond and Share Company

The Electric Bond and Share Company was separated from the General Electric Company in 1927 by the distribution of its stock held in the General Electric Company treasury, to General Electric stockholders Since that time, it has gone more extensively into the purchase of public utility securities, especially in Latin America and more recently in China, through its control of the American and Foreign Power Company, which recently raised $100,827,000 of new capital for the purpose of making additional purchases The peculiar advantage of such holdings lies in the fact that rates and prices of utility corporations are not regulated as in the United States The chief concern is to obtain service The Electric Bond and Share Company is still working in close harmony with the General Electric Company, but it has expanded into a finance holding company on a large scale. In addition to the American and Foreign Power Company which it controls, it has large holdings in the American Power and Light, the Electric Power and Light, and minority interests in the American Gas and Electric, and Electric Investors, Incorporated. For all these groups of companies, as already explained in

the discussion of horizontal consolidation, the Electric Bond and Share Company performed general management service, including operation, financing, engineering, accounting, rates, and policy services. For these services it charged fees which, it is reasonable to suppose, represented in the aggregate a large income. The company has now grown into a vast enterprise with $557,091,477 of assets and with a surplus of $376,759,571 on December 31, 1939. The company still continues its security operations, buying and selling utility securities as before, which it does not consider as permanent investments as it considers the five companies above mentioned. The close affiliation with the General Electric Company still continues, since the stockholders are still largely the same persons

Financing Subsidiary Companies

The method of financing companies controlled by a holding company varies with the size and credit of the subsidiaries. If the subsidiary is large and its securities are well known, it handles its own financing When the controlled company is small, the parent company makes advances to the subsidiary, taking securities in exchange, which are held in its treasury and used when need arises as a basis for collateral trust issues Only the largest operating companies, such as the Detroit Edison, controlled by the North American Company and the Philadelphia Electric controlled by U G.I., can raise money on as favorable terms as can the large holding companies

In the difference between the cost of the money to the parent company and what they charge the subsidiaries, they find another opportunity for profit. There is nothing unfair in this, as long as they lend money to their subsidiaries at lower rates than the subsidiaries could borrow for themselves A higher rate would, of course, be a ground for criticism, and possible interference by the public authorities. It is not unreasonable to suppose that, so far as it is legitimate and proper, of which the holding companies officials were formerly the judges, the affairs of the subsidiary companies are now subject to the control of the Securities and Exchange Commission and the Federal Power Commission.

The Railroad Holding Company and the Interstate Commerce Commission

An interesting development of the holding company in the field of railroad securities is its use to escape the control over security issues, especially in connection with consolidations, which the Transportation Act of 1920 gave to the Interstate Commerce Commission The Commission has been very critical of the consolidation plans submitted. No plan of major importance has been approved The Commission has relied upon the fact that consolidations can not be financed without security issues and that such issues must have their approval The Commission's jurisdiction, however, does not extend to holding companies, and such large-scale consolidation as has been done, has been put through holding companies, thus evading the Commission's control For example, when the Pennsylvania Railroad Company wished to finance its purchase from the Delaware and Hudson of that company's holdings of the Wabash and the Lehigh Valley, it did this through the Pennsylvania Company, a holding company, all of whose stock is owned by the Pennsylvania Railroad Company. The Pennsylvania Company took over, from its owner, the stocks in question and issued its collateral trust bonds, secured by the stocks purchased. The Interstate Commerce Commission was not consulted and had no ground to interfere, although it has since attempted, on other grounds—the alleged violation of the Clayton Act—to force the Pennsylvania Railroad Company to divest itself of control of these stocks.

The Pyramidal Holding Company

To erect a pyramid of earnings by following the method long in use is to convert dividend-paying common stock of an operating company into fixed return bonds or preferred stock issued by another company which takes over control. The original holders of the stock profit by this exchange, in that they receive something whose return is fixed in a contract and not to be changed by the decision of directors. When the purchasing company is strong in earnings, which is usually the case in the public utility field, and since this strong company has placed bonds or preferred, or A stock issued to purchase the common stock of the operating company, ahead of its own common stock, there is no reason to doubt that interest or preferred dividends on the securities issued in the

transaction will continue to be paid. How can the purchasing company, the first holding company which starts to build the pyramid, make any money out of taking over a group of operating companies on a basis such as described? We have already shown some of the profits of such a relationship in management fees, engineering charges, and financing charges. Beyond this, there is the opportunity to profit by the increase in the earnings and dividends on the stock purchased.

Pyramiding by Means of the Lease

A method of accomplishing this result formerly in common use, extensively employed in the street-railway consolidations of the period 1890-1910, was to organize a company, or use an existing company which would lease the desired line, paying as rental a fixed dividend on the stock By such an arrangement, the return to the stockholders of the leased company, the landlord, was fixed, and all increases on earnings went to the tenant. When operating earnings move rapidly upward, as they did in the early days of electric traction in large cities, this process of leasing was sometimes, as in Philadelphia, several times repeated. A group of operating companies would be leased for a fixed dividend on their stocks by another company, into which sufficient money would be paid as subscription to its stock to give some value to the tenants' obligation. The tenant would then operate these leased properties, and the rapid growth of earnings which at that time generally blessed street railways in large cities, quickly showed a large profit over the rental.

In a few years, conditions favoring, the operation would be repeated Two or more of these leasing companies would in turn be taken over by a new company, which would guarantee a fixed dividend on this stock, and assume the burden of paying the rentals of the companies owning the street-railway properties From time to time, also the tenant companies, out of their capital and earnings, would make improvements on these leased properties, all of which went to the company owning the property They built new power-houses, car-barns, and purchased new equipment as the old equipment became obsolete Finally, as in Philadelphia, the third lease-holding company, the Union Traction Company, was taken over by a third holding company, the Philadelphia Rapid Transit Company, as already explained in the chapter on the lease. The method was the same, a guarantee of 6 per cent dividend on the stock

of the Union Traction Company, par $50, on which $17.50 per share had been paid,[2] and the assumption by the Philadelphia Rapid Transit Company of all the lease obligation which had been successively assumed by the original leasing companies and the Union Traction Company. This operation is called pyramiding—and the result is a pyramidal leasing (holding) company.

These successive leases were very attractive to the stockholders of the companies which either owned or successively controlled the original properties and the additions thereto Their stock was, by the terms of the leases, converted into guaranteed stock, and they were freed from the risks and uncertainties of operation.

Pyramiding a Capitalization of Leasehold Profits

It will be noted that the basis of these successive stages in consolidation is an increasing fund of earnings out of which the accumulation of a series of rentals or guaranteed dividends is paid, leaving a margin of earnings out of which dividends on the stock of each succeeding lessor is paid If earnings cease to expand, the last company to assume the obligation of paying the accumulated charges of its predecessor companies in control of the property is not likely to be profitable. This has been true of certain street-railway consolidations. The Philadelphia Rapid Transit Company, for example, was launched in 1902 and paid no dividends until 1916, although the companies which preceded it were very profitable until taken over.

The lease has gone out of fashion in forming these consolidations. In recent years, first bonds, and later preferred or A stock have been employed. The underlying method is, however, the same, to exchange a senior, fixed return security for a junior security, common or B stock, the purchasing company expecting that earnings will increase sufficiently to show a profit derived from increased dividends on the stock purchased, for its own stock, after paying interest or dividends on the securities issued in the exchange.

When common stock is purchased with common stock, there is no pyramiding, since the stockholders of the company purchased participate, pro rata to their proportion of the purchasing company's stock, in all increased dividends on the stock which they formerly owned. *The underlying idea of the pyramid, to repeat, is to fix a return on the securi-*

[2] Stock of the Union Traction Company was originally issued as assessable stock

ties issued for stock purchased, so that the stock of the purchaser will gain the entire advantage of increased dividends on this stock. To the extent that the securities given in exchange for stock in building the successive levels of the pyramid are participating with the junior stock of the purchasing company, the principle of pyramiding is departed from The same qualification may be made when subscription warrants or conversion rights are given with the securities used to purchase common stock.

When the purchasing stock is made non-voting, along with a fixed dividend return, a pyramiding of control takes place, together with a pyramiding of earnings The stockholders of the controlled company are voluntarily disenfranchised and have no voice in the election of directors of the company which now controls their former property.

In the public service field, especially in light and power consolidations, this method of the pyramidal holding company has been extensively employed.

The Evils of the Utility Holding Companies

The holding company reached the peak of its development in the public utility field In the boom period of the late twenties we find these companies in full flower The fertile soil of a rapidly growing demand for their services was further enriched by public indifference and hysterical speculation Some of the plants were strange exotic growths with foul odors. Others, carefully pruned and restrained, were useful features to our economic system. With the collapse of the boom in 1929 and the agonies that followed, the evils of the holding company were quickly brought to public attention. The holding company is admittedly a useful instrument in bringing about consolidations which would otherwise be impossible and can be used to develop a service more rapidly and at lower cost to the consumer. The evils have grown out of abuses so common in a laissez faire economy The holding companies were not themselves held to be public utilities and were therefore but little regulated by the states. The federal government had not provided for their control so that in matters of security issue, accounting, and service charges, all of which are related to the rates charged by their subsidiaries, the holding company management had a free rein.

A thorough investigation by federal authorities in the early thirties emphasized three serious evils of the utility holding company

1. Uneconomic integration of properties which violated sound tenets of engineering technique and operating efficiency. Many consolidations were not carried out because they would enhance efficiency, lower costs and finally rates, but because they increased the opportunities for promoters' profits through security sales.

2. Service charges of many varieties levied against the operating companies by the holding companies which control them. These charges are part of the operating expense of the operating company, deductible before profits are computed, which profits must yield a fair return upon the value of the assets used No one denies that such expenses are legitimate, but it is claimed that in many cases the operating companies paid exorbitant prices for them. If fees for management, financial advice and help, and the price of raw materials and equipment bought, are set by the holding company without competitive bidding, the door is open for unscrupulous management to bleed the operating company for the benefit of the holding company and at the same time prevent a reduction in the cost of operation which would justify a reduction of rates to the consumer. The holding company, in effect, could control the flow of money into its own treasury in order to support its top-heavy capital structure. As James C Bonbright remarked in 1932, "the whole practice by which a public utility system trades with itself through profitable transactions between the holding company and its subsidiaries, is fundamentally vicious." [8]

3 Lack of control over holding company security issues resulting in overcapitalization. In most of our states the operating utility companies must have the approval of the public service commission before issuing securities. In some states the commission must approve the type of security, the amount of issue, the purpose for which issued and then check upon the expenditure of the proceeds All of this is for the purpose of preventing overcapitalization and unwise extension of plant which might result in excessive rates. The holding company could issue securities without let or hindrance Many of their issues were sold to provide the means to purchase the common stocks of operating companies which were bought for far more than their book values. Fancy prices were often paid for such control in prosperous times when price-levels were rising and consumption of electricity was rapidly increasing This re-

[8] "The Evils of the Holding Company," James Cummings Bonbright, *The Annals*, January, 1932, p 4

sulted in inflation of the capital structure of the holding company. The credit of the holding company could only be maintained by a flow of dividends and income from service charges upstream from the operating company, sufficient to maintain interest and dividends on the holding company securities This completed the vicious circle—uneconomic grouping of properties, dominated by a holding company which could exact service charges and dividends from the operating companies in order to support the capital structures of a pyramid of holding companies, whose security issues were not subject to any kind of public control and whose accounts and records were not available for public analysis The consumer who pays the rates and provides the capital is charged more than he should be for the service and owns securities whose values are precarious.

The Public Utility Holding Company Act

The unprecedented collapse in security values, from 1929 to 1932, especially pronounced in holding company stocks and bonds, the fall of the Insull utilities empire, and the rapid decline in business earnings and individual incomes, together with the publicity given to holding company evils by federal investigation, convinced the public that the holding company should be regulated After a prolonged period of investigation and hearings, the Federal Congress passed the Public Utility Holding Company Act of 1935 With one comprehensive law the public utility holding company was brought as completely under government control as were the railroads after years of amendment to the Interstate Commerce Act. The extent of the control will be shown by the following summary of the Act

1. The administration of the Act is placed with the Securities and Exchange Commission, with which every holding company which has marketed securities in interstate commerce during the previous five years is required to register. If not registered with the Commission, such holding company is prohibited from carrying on any of its customary business affairs

2. The Commission is given control over holding company security issues to the extent that, with minor exceptions, no securities may be issued without Commission approval The Act specifically limits holding company securities to voting common stock having a par value, bonds secured by a first lien on physical assets, or by first-mortgage bonds of

subsidiary operating companies which are so secured, and receiver's and trustee's certificates Holding companies can no longer finance their purchase of control in operating companies by issuing debentures, collateral trusts, or preferred stock. This is a direct blow at pyramiding

3 The Act specifically prohibits a registered holding company from controlling, at the same time, natural gas or electric operating companies, an electric and gas utility serving the same territory, if the state law prohibits their combination in a single company, unless approval of the state commission is obtained, operating utility companies within and without the United States, unless the Commission considers them to be economically and geographically integrated.

4. A registered holding company or subsidiary thereof may not acquire securities or capital assets without approval of the Commission. In order to obtain approval the holding company must furnish the Commission with information to satisfy it that the public interest and the interests of investors and consumers will be protected. This provision of the Act gives the Commission authority to pass upon further consolidations in the utility field before they are consummated.

5. The Commission is required after January 1, 1938, to order the simplification and reorganization of holding companies for the purpose of eliminating those which are without public advantage as geographically and economically integrated systems. Each registered holding company must take steps to limit the operations of its system to a single integrated public utility and to such other businesses as are reasonably incidental or economically necessary or proper to the operation of such system. This is the much discussed "death sentence" provision of the Act which aroused widespread complaint on the part of holding company managements and groups of investors in holding company securities. Under certain conditions a registered holding company may be permitted to control one or more additional integrated systems, but the structure of the holding company system will be limited to three tiers consisting of operating companies, first-degree holding companies and a second-degree or top holding company Compliance with this section of the Act may be brought about in either of two ways (1) an order of the Commission enforced through the courts, or (2) a voluntary plan submitted by the company and approved by the Commission. This section also provides for stringent regulation of voting control among

security holders to promote fairness and equity to all types of securities. The Act provides that after January 1, 1940, the Commission must order every registered holding company to dispose of securities or be reorganized in conformity with the law, or be dissolved

In the event that reorganization is undertaken, the Commission is given wide jurisdiction in the proceedings and shall act as trustee or receiver to dispose of assets. It may also institute proceedings to bring about reorganization if necessary under Section 77B of the Federal Bankruptcy Act. No reorganization plan shall be effective without Commission approval

6. The act prohibits up-stream loans, and loans, fees, and commissions on transactions of companies in the same system It prohibits payment of dividends out of capital surplus or the acquiring, retiring, or redeeming of securities by holding companies contrary to Commission rules Capital assets or securities may not be disposed of except by commission rules governing price, fees, competitive bidding, and disclosure of interest. These provisions aim to prevent the milking of operating subsidiaries and the swapping of assets at inflated prices to forestall rate reductions and improve the appearance of subsidiary balance sheets

7 The service charge evil is attacked by prohibiting, after January 1, 1936, any registered holding company or its subsidiary from performing service, sales, or construction contracts with controlled or affiliated operating companies. A registered holding company may not perform such contracts with any public utility company. Permission is granted under the act for creating mutual service companies, approved by the Federal Power Commission, such companies to work on a cooperative basis and render services at cost which must be substantially less than the prices of independent companies. The mutual service company is subject to continuous supervision by the Power Commission with respect to reports, accounts, costs, competitive bidding, and disclosure of interest This sweeping provision aims at elimination of a very substantial source of holding company income and the padding of operating utilities costs with exorbitant service charges, thus preparing the way for rate revision downward.

8 Registered holding companies are required to file regular and periodic reports in the form and containing information prescribed by the Commission. In addition, the holding company and its subsidiaries

must keep accounts according to the rules of the Commission and the latter is required to prescribe uniform methods of accounting For the first time a governmental regulative body is in a position to examine utility holding company accounting records in detail.

9. Finally, the Act imposes the same civil liability for false or misleading statements filed with the Commission as that provided in the Securities Act of 1933 and the Securities and Exchange Act of 1934, and defines offenses subject to criminal penalties.

Following the passage of the Holding Company Act there was much controversy over certain of its provisions and their constitutionality. At first many companies refused to register with the Commission and went to court to test the right of the Commission to compel registration. In 1937 the United States Supreme Court upheld the Act in this respect, in the Electric Bond and Share Company case, since which time all of the companies have registered or sought exemptions under the discretionary powers of the Commission Other cases pending have attacked the Act as invalid on the grounds that Congress flagrantly exceeded its power under the commerce clause of the Constitution and under the postal power, that due process of law under the Fifth Amendment to the Constitution is violated, and that Congress, by the Act, has unlawfully delegated to the Commission, without establishing adequate and intelligent standards to guide and assist it, the legislative power to determine when and to what persons and corporations the Act shall apply Holding company officials have stated that the Act is not designed to regulate interstate commerce and the mails, but to destroy public utility holding companies Much can be said for their viewpoint. The crucial test of the law will occur after 1940. The attitude of the Commission in carrying out its mandate will be of particular significance.

A number of holding companies have submitted voluntary plans of reorganization designed to meet the provisions of the Act The first voluntary plan to be approved by the Commission was that of the American Water Works and Electric Company Before reorganization, the top company was a fifth-degree holding company in one relationship and a fourth-degree holding company in another After reorganization the top holding company controlled three subsidiaries which were both holding and operating companies, which in turn controlled an underlying tier of operating companies. There have been a few additional

reorganizations, voluntarily proposed, which have been fairly easy to accomplish.

Early in 1940 the Commission instituted proceedings against the Electric Bond and Share Company and Engineers Public Service Company to bring about reorganization. It also served notice at the same time that it would soon bring similar proceedings against seven other major holding company systems—the Middle West Corporation, The United Gas Improvement Company, Cities Service Power and Light Company, Commonwealth and Southern Corporation, Standard Power and Light Corporation, North American Company, and the United Light and Power Company. During the next few years we shall be able to appraise the effectiveness of holding company reorganization Little can be said conclusively at this writing

The Federal Income Tax Law and Holding Companies

The use of the holding company is further handicapped by provisions of the income-tax law In 1934 the federal government withdraw from holding companies the privilege of filing consolidated returns. Prior to this change, by means of consolidating the earnings of all subsidiaries, it was permissible to offset the losses of certain subsidiaries against the profits of others, which produced a smaller tax base Now the income tax must be paid on all profits. In addition an increasing portion of the dividends received by holding companies from their subsidiaries are subject to tax, whereas prior to 1934 such dividend income was not taxable.

Significance of Holding Company Regulation

Public utility holding companies have been brought under effective regulation for the first time Through the Holding Company Act, the Securities Act of 1933, and the Securities Exchange Act of 1934, not only the holding companies but many of their operating subsidiaries are subject to a degree of publicity and control not previously possible under multiple state regulation

If public utility holding company regulation should follow the same trend that railroad regulation has followed and there has been no noticeable contrary shift in governmental or court attitude to date, the Securities Exchange Commission will gradually absorb an increasing degree of control over the entire industry As Interstate Commerce Commission

regulation has tended to predominate in railroad control, so will federal regulation with respect to the utility industries.

Holding companies in other business fields than utilities and rails, as yet not sufficiently freighted with a public interest to be subject to some form of commission control, would be well advised to eliminate any abuses similar to those responsible for the Public Utility Holding Company Act. An aroused and enraged public opinion can bring about strenuous correctives.

CHAPTER 39

READJUSTMENTS OF THE CAPITAL ACCOUNTS

The capital accounts of a corporation are the asset and liability accounts which appear from time to time on the balance sheet The balance sheet, which is prepared periodically to show the financial condition of the business, is a picture giving the debit or credit balances of the company's various capital accounts as of a certain date, those with debit balances listed as assets and those with credit balances as liabilities

Every corporate act involving an accounting transaction results in a change or readjustment of one or more capital accounts. We are not concerned here with the routine day-to-day activities involving purchase of inventory or sale of commodity or collection and payment of moneys due Our interest is centered on those unusual acts undertaken by the management, either as corrective measures, or efforts to avoid difficulties which threaten the business From time to time, it becomes necessary or advantageous for a company to readjust its capital accounts, either by changing the form of assets, exchanging assets for liabilities, distributing assets or evidences of liabilities to stockholders or creditors, or changing the form of liabilities. The methods employed in making these readjustments, we group under the general title of readjustment of the capital accounts.

Readjustment of the capital accounts is usually required in bankruptcy reorganization This form of reorganization will be considered in later chapters We are here concerned with the readjustment of the capital accounts of solvent companies.

The reasons for readjustment are varied. More than one method may be used to accomplish a purpose, although practice has standardized the methods used for the attainment of certain objectives. The following table has been prepared to show the varied purposes or reasons for voluntary readjustment of the capital accounts and opposite each of them the method or methods that might be applied. It is not intended that either the reasons or the methods be all-inclusive. The data upon which the table is based were gathered from a long list of readjustments

undertaken or proposed by many corporations over a period of years as presented from time to time in the *Commercial and Financial Chronicle*. In stating the reasons for the readjustments, we have taken them as announced by the management, or we have drawn our own conclusions with respect thereto from the ultimate effect of the readjustment upon the financial set-up. In some instances the management may announce one reason for a change when a more potent one may underlie the move

VOLUNTARY READJUSTMENTS OF CAPITAL ACCOUNTS

Purpose of or Reason for Readjustment	*Methods Used*
1 To improve working-capital position.	1 Sell equipment or real estate no longer needed 2. Sell securities no longer needed for control 3 Sell bonds or increase bond issue 4 Sell additional stock 5 Pledge current assets to secure short term loans
2 To reduce pressing current liabilities	1. Reduce current assets to pay current debt 2 Sell property to pay off floating debt 3 Sell stock to pay off floating debt 4 Sell bonds to pay off floating debt
3 To increase common-stock equity.	1 Purchase their own bonds when prices are low and cash position is strong. 2 Purchase their own preferred stock under similar circumstances.
4. To placate stockholders when current earnings are low or the management desires to reinvest profits	1 Stock dividend 2 Property dividend *a*. Company product *b* Distribute securities no longer needed for control
5. To improve market price of stock when earnings are persistently low.	1 Reduction in number of shares outstanding to raise dividend rate 2 Change from par to no par with low stated minimum.

VOLUNTARY READJUSTMENTS OF CAPITAL ACCOUNTS—*Continued*

Purpose of or Reason for Readjustment	*Methods Used*
6 To reduce fixed charges or senior dividends and improve earnings on common stock.	1 Retire preferred stock with proceeds of a bond issue. 2. Exchange one type of stock for another 3. Refund short term notes 4 Retire high interest bearing bonds with proceeds of sale of lower interest bearing bonds 5 Retire high interest bearing bonds with proceeds of bank loans
7. To permit payment of dividends	1. Reduce stated value of capital stock to permit cancellation of treasury stock 2 Reduce par value. 3 Reduce number of shares
8. To settle senior dividend arrearages	1 Pay dividends in common or another class of preferred stock 2. Pay dividends in cash, bonds and common stock 3. Pay dividends in stock senior to existing preferred 4. Reclassify preferred stock.
9 To extinguish a deficit.	1 Reduce number of shares of stock 2 Reduce par value of shares outstanding 3 Change from par to no par shares with a lower stated minimum per share than the former par.
10. To provide a reserve as an offset to assets of doubtful value	1. Reduce the aggregate par or stated value of capital stock the same as for Number 9 above.
11. To increase flexibility of financial set-up.	1. Change from par to no par stock

VOLUNTARY READJUSTMENTS OF CAPITAL ACCOUNTS—*Continued*

Purpose of or Reason for Readjustment	*Methods Used*
12. To avoid default.	1. Fund interest coupons due on bonds 2. Deposit interest coupons due on bonds with or without interest thereon 3. Conversion of bonds into stock. 4. Conversion of one bond issue into another 5 Extension of maturing bonds 6. Borrow from banks to pay maturing bonds.
13 To eliminate a mortgage with serious restrictive covenants.	1 Sell a new bond issue under a more lenient mortgage
14 To reduce market price of shares and broaden market for shares	1. Stock split-up 2 Stock dividend
15. To avoid the undistributed profits tax.	1. Pay dividends in company obligations 2 Pay dividends in stock when such dividends are taxable to the recipient 3. Give the stockholder the choice between a non-taxable stock dividend and a cash dividend.
16. To comply with provisions of the Public Utility Holding Act of 1935	1. Varied rearrangements of capital structure to produce simplification

Improvement of Working-Capital Position

It has been explained in a previous chapter that corporations frequently finance their growth or expansion in large part by reinvestment of profits. When this is done, the money needed to pay for the new assets is taken from the income of the company, unless a funded reserve, easily tapped, has been built up for the purpose. Expansion, if wisely undertaken, results in larger volume of business, which in turn neces-

sitates larger inventories, pay-rolls, and other operating expenses This growth in size will require a larger working capital Since a portion of the working capital may have solidified in new fixed assets, the corporation may feel the lack of cash to meet routine expenditures If the regular volume of current assets does not exceed current liabilities by sufficient amount, its credit will suffer A wise management corrects this condition before some form of delinquency casts a shadow on the company's reputation.

The simplest solution is to convert some assets into cash If there is any equipment or real estate not needed, provided it has not been pledged as security for a loan, it may be sold. If it has been so pledged, this method will not serve, since the contract of pledge invariably provides that the proceeds must be used to retire the secured loan or to purchase other assets to serve as security Should the proceeds of sale exceed the loan, the company would have a small amount of cash. Occasionally the corporation may sell portions of its real estate for cash, with a contract or option to repurchase at a later date. The repurchase price may be high enough to include adequate payment for the use of the funds. Sometimes a rental is paid the temporary purchaser. On occasion, such a temporary sale will produce more cash than could be borrowed with the real estate as security. In 1921, Julius Rosenwald came to the assistance of Sears, Roebuck and Co. by purchasing from it certain lands and plants, in the city of Chicago, for $16,000,000. At times the corporation may own securities of other corporations, originally purchased for the purpose of control Altered circumstances may have eliminated the need for control, and these securities may be turned into cash through sale Such was the case with the Union Pacific after the dissolution by court order of the Northern Securities Company. The former had come into possession of shares of Great Northern and Northern Pacific which it did not particularly want, but which had a market price greatly in excess of their cost A majority of these shares were sold at a handsome profit, and were invested in other securities.

In 1934, the Caterpillar Tractor Company, in anticipation of redemption of $5,000,000 5 per cent notes, took advantage of the sharp rise in the public bond market, and sold its holdings of short-term United States Treasury Certificates and municipal bonds at a substantial profit. With the proceeds of this sale, plus cash on hand, the company redeemed the notes, and improved its current position

If none of these methods are available, the company may sell bonds or stock. If bonds are sold, a long-term debt obligation is assumed which, if the proceeds added to working funds are sufficiently productive, may not become burdensome Again, if shares are sold, the net income may be increased, so that earnings available for dividends on the increased number of shares outstanding will not decline. Neither of these operations, however, is as simple as the asset conversions described above. They usually require stockholders' consent, the cooperation of investment bankers, and favorable market conditions.

Another method of readjustment frequently used is the pledging of current assets to secure short-term loans If the company owns marketable securities held for temporary investment, and the market is lower than cost, rather than take a loss on their sale, it may be better to pledge them as security for a loan. As a last resort, if no marketable securities are owned, the company may borrow on its receivables. This device should only be used as a measure of extreme necessity.

The Reduction of Pressing Current Liabilities

The management may find that conditions beyond its control, such as a sudden cyclical change in business activity, will present serious difficulties Commitments made when business is active and the future appears secure, if a reversal occurs, may develop into pressing current liabilities. Such was the situation in 1921, when manufacturers and merchants were heavily stocked with inventories largely purchased with the proceeds of bank loans Business had boomed in 1919 and 1920, and the future seemed bright Normally, the loans would have been extinguished in orderly fashion as goods were sold. Partial renewal would have eased the pressure in those cases where more time was needed But the banks were forced to call loans or refuse renewals Many corporations were faced with the problem of maturing loans and insufficient cash. Others had to satisfy clamorous merchandise creditors, and could not borrow from banks to pay them In short, many companies had current liabilities in excess of current assets, and others found their current assets insufficiently liquid to provide the means for payment.

Other conditions may be responsible for pressing claims. A corporation may undertake a program of expansion and finance the cost of new property acquisition by means of bank loans or by using cash on hand,

expecting to issue securities before the bank loans are due, to provide for paying the loans.

The methods which may be used to meet such situations are similar to those described above for improving the working-capital position. Current assets, such as inventories and investment securities, may be sold, or any property or equipment not needed may be converted into cash if a market can be found More common, however, when the sums borrowed are large, is the sale of new securities, either bonds or stock. This was the method generally used in 1921 Many corporations floated bond or stock issues and liquidated their bank loans with the proceeds. Typical of such readjustments was the issue of $5,500,000 of debenture bonds and 7,819 shares ($100 par) of cumulative preferred stock by the Champion Paper and Fibre Company early in 1938. As announced in the registration statement, filed with the Securities and Exchange Commission, the net proceeds of the debentures were to be applied to the following

1. Retirement of $2,800,000 of bank loans,
2. Retirement of $800,000 of outstanding commercial paper,
3. Retirement of $200,000 of purchase money obligations,
4. To finance $100,000 worth of additions and betterments to plant,
5. To increase working capital by the balance

The proceeds of the sale of preferred stock were to be used for improvements and betterments to the mills and to increase working capital Of the above expenditures, $3,800,000 was used to pay off pressing current liabilities

Increasing Common-Stock Equity

When senior securities are outstanding, the equity of the common stockholder in the corporate assets is determined by deducting from tangible asset value all liabilities and the claims of any shareholders having preference over him. The amount remaining, divided by the number of shares outstanding, represents the book value per share of the common stock. Any financial operation which eliminates a portion of the bonds or preferred stock of the company without a corresponding decrease in assets will increase the common-stock equity, and, in addition, improve the earnings per share on common stock.

During a period of depression, and particularly a severe one such as 1931 to 1933, when bonds and equities are cast overboard at distress prices, corporate managements have been extensive buyers of their own securities The motives for such action are frequently mixed The management of a sound corporation may buy to support the market and preserve its credit. It may, if convinced that panic selling will soon end and prices sharply advance, buy for market appreciation and a quick profit. Again, if its bond prices are low, the company can anticipate several years' sinking fund requirements at substantial savings. Bonds of an issue can be used at par to meet sinking fund requirements on that issue. Or it may, as indicated above, buy its securities at distress prices and cancel them after purchase, thus eliminating par or stated value of bonds or stock through the expenditure of a smaller amount of cash If the securities so purchased are senior to common stock, the equity of the latter is increased. Such adjustments can be made without financial strain due to the normal rise in cash account when business is dull. During the period mentioned above, over two hundred and fifty corporations listed on the New York Stock Exchange re-acquired portions of their own stock The practice of re-acquiring preferred and common stock under such conditions should be condemned when the management has contributed toward the low market prices by reduction or passing of dividends. It is especially objectionable when, as has sometimes happened, the management made an agreement with some of its officers and directors to sell the shares so acquired to them at attractively low prices.[1]

Placating Stockholders When Current Earnings Are Low or Profits Are to Be Reinvested

One of the rights of stockholders is that of sharing in the profits of the business, when profits have been earned and the management believes that a distribution can be safely made But business does not run a smooth and even course Earnings fluctuate widely. If the corporation has been a regular dividend payer, and, in addition, has retained a portion of the profits so that earned surplus has grown, management will try to avoid passing of dividends. While the cash balance may not be sufficient to justify a cash payment, a stock dividend may be declared.

[1] For an enlightening discussion of the abuse of shareholders through open-market purchase of shares by corporations see Graham and Dodd, *Security Analysis*, 1934, pp 518 to 520

The stockholder can sell his new shares or fractional rights or retain them. No part of the assets has been disposed of. The stock dividend may be used again under different circumstances. A growing or expanding business needs new capital. At times it may be unwise to attempt the sale of additional securities. Profits may be used to build or buy the new plant and equipment A stock dividend, accompanied by a hopeful forecast of greater profits to come from the expansion program, may be used to satisfy the shareholders

Occasionally a corporation may use the property dividend for either of the above purposes When this is done, assets and surplus are reduced, but the cash is retained for more urgent needs.

To Improve the Market Price of Stock When Earnings Are Persistently Low

When the company has outstanding an amount of stock so great as to make it improbable that its earnings will ever reach a point where dividends can be safely paid, and especially when there has been such an accumulation of unpaid dividends on preferred stock as to make payment of dividends on common stock unlikely, the question arises, shall the capital stock be reduced to a dividend-paying basis? When the value of the stock, because of the remoteness of dividend payment, has fallen to a nominal figure, this question may be answered in the affirmative.

A company, for example, with $500,000 of surplus earnings applicable to dividends can not, as a rule, safely pay out more than $300,000. If $250,000 of this $300,000 is required to pay preferred dividends, and if the amount of common stock is $10,000,000, the $50,000 remaining equals only one-half of one per cent on the total common stock. There may also be accumulated dividends on the preferred stock, making the payment of dividends on the common stock even more improbable. Common stock, under these circumstances, will usually sell for a nominal figure, under $5 a share. Very little of it can be sold at any price. If, however, the $10,000,000 of common stock could be reduced to $1,000,000, and the accumulated dividends on the preferred stock liquidated, the company would have enough surplus earnings to pay 5 per cent on its common stock, which might be expected to sell at from $50 to $60 a share. The proposition made to the common stockholders to exchange, say, ten shares of the old stock for one share of the new stock should be acceptable, since they obtain an income at once, and

also a more active market for their securities. In case the increased earnings of the company eventually make it possible to pay a high dividend on this reduced capital stock, the stock retired may be returned to the stockholders in the form of stock dividends, maintaining a dividend rate at a reasonable figure, and placing them again in their original position so far as concerns the par value of their holdings This method was employed by the General Electric Company, which in 1898 reduced its stock 40 per cent, in 1902 returning the amount to its stockholders in a special dividend

The same result may be obtained by reducing the par or stated value of the stock instead of reducing the number of shares outstanding. For example, in May, 1935, the shareholders of the American Smelting and Refining Company ratified a plan to readjust the capital stock by reducing the stated value of the common shares from \$33⅓ to \$10 per share One of the reasons given was that it would advance the day when dividends may be paid on the various classes of stock by setting up a surplus out of which dividends can be paid when warranted by the company's cash position. Moreover, the readjustment facilitated permanent registration of the company's securities on the New York Stock Exchange under the terms of the Securities Exchange Act of 1934 which provided a freer market for transactions. The company had paid 12½ cents per share in 1932 and none thereafter until 1936, when \$4 05 was paid. In 1937 the common stock received \$5 per share The stock fluctuated in price from a low of 5⅛ in 1932 to a high of 53½ in 1933 It did not reach this figure again until December, 1935, when it sold at 64⅝ For a few weeks prior to the readjustment described above, the common sold between 31⅝ and 47⅛ With the exception of a slight drop during the summer months it rose steadily to the year's high of 64⅝. In 1936 dividends were resumed, the stock reached 103, and, in 1937, sold for 105¾. Without this readjustment, dividend payments would not have been possible.

Reducing Fixed Charges or Senior Dividends and Improving Earnings on Common Stock

Prudent managers are on the alert, when opportunity presents itself, to reduce fixed charges or dividends on senior stock. This is especially true when the management is largely elected by and owns substantial portions of the common stock The five years preceding 1938 have

offered unprecedented opportunities for corporations to undertake the type of readjustment which we now discuss, and the extent to which it was done was phenomenal. During this period of cheap money, the 5 to 6 per cent bonds and preferred stocks of corporations whose earnings had been well sustained, rose in price to substantial premiums. The banks were overloaded with idle funds. Individuals with excess income to invest in the face of a decline in corporate offerings were willing to accept lower rates of return One of the results was an extraordinary volume of redemption of callable bonds or, as the operation is commonly called, refunding The following table shows the extent of this activity from 1934 to 1938

NEW CORPORATE ISSUES IN THE UNITED STATES FOR 12 MONTHS ENDED DECEMBER 31 [2]

YEAR	TOTAL ISSUES	REFUNDING	PER CENT OF REFUNDING TO TOTAL ISSUES
1934	$ 491,094,000	$ 312,837,000	64
1935	2,267,429,000	1,863,859,000	82
1936	4,631,946,000	3,416,995,000	74
1937	2,435,739,000	1,208,709,000	50
1938	2,075,798,000	1,221,379,000	59
	$11,902,006,000	$8,023,779,000	67

Over eight billion dollars or 67 per cent of the new bond issues floated during this period were refunding issues undertaken, for the most part, for the purpose of reducing fixed charges If we assume a saving in interest of 2 per cent, which would not be too high, it represents a reduction in annual interest of more than $160,000,000.

Other corporations, in large numbers, called their higher interest bearing bonds and paid them off with the proceeds of bank loans The commercial banks have been hungry for business, and many of them have loaned for this purpose on series of notes due to mature over a period of years. Such loans are not based upon self-liquidating transactions, the ideal bank loan to business for working-capital requirements, but bankers have been willing to put a portion of their idle funds to work in this fashion in order to increase bank earnings. Just how ex-

[2] Figures from *Commercial and Financial Chronicle*, Jan 7, 1939, p 25.

tensive this method of refunding has been is difficult to ascertain but it has been large in total.

The Chrysler Corporation used this method in 1934 when it paid off all of its outstanding bonds ($30,150,500 of 6 per cent Debentures of Dodge Brothers, Inc) by borrowing from its banking connections $25,000,000 in the form of one-, two-, three-, four-, and five-year notes and providing the balance of the cash out of its own funds The interest saving to the corporation was approximately $1,200,000 annually

Some idea of the interest rates acceptable to banks during this period is given by the loan made by the Glidden Company in 1936 for the purpose of retiring all of its funded debt. They called $3,260,000 of 5½ per cent debentures at 101 and borrowed most of the cash on a three-year bank loan at 2½ per cent Such reductions in interest payments increase earnings available for dividends on common stock The Snider Packing Company announced, in 1935, that retirement of its entire mortgage debt, partly by bank loan and partly with surplus cash on hand, would result in an average annual interest saving equal to 40 cents a share on the corporation's 210,000 shares outstanding.

The Standard Oil Company of New Jersey called for redemption on February 1, 1935, $90,000,000 of 5 per cent debentures using a combination of surplus cash of its own, bank loans, and a refunding issue of serial debentures with lower interest rate. In discussing this operation the *Commercial and Financial Chronicle* quoted the president of the company as follows

> The interest saving to the company's stockholders is substantial, and the directors feel that the financing of the obligations maturing over the next six years, to a final extinguishment of the debt, presents a sound and workable program. It is in accord with the procedure followed by the company in making substantial reductions periodically of obligations ahead of its common stock. This process began in 1927 with the redemption of its $200,000,000 of preferred stock.[8]

Another method of readjusting the capital accounts to improve earnings on common stock is the retirement of preferred stock issues through borrowing Here the management chooses to substitute a debt, either in the form of a bond issue or a series of notes to commercial banks for a special class of ownership or equity. It can only be done if the

[8] *Commercial and Financial Chronicle*, Nov 17, 1934, p 3165

preferred shares are callable Purchase in the open market would normally drive the price of the preferred stock too high to be economical Despite the undesirability of debt, with its burden of fixed charges, in the capital structure, there may be strong arguments in favor of the shift. The first of these is again cheap money This is illustrated by the statement made by the president of the Southern California Edison Company, when the company called for redemption $24,000,000 of 7 per cent preferred stock in 1935 to be paid from the proceeds of the sale of 2½ per cent and 3½ serial debentures

> The retirement of the company's 7% preferred stock is clearly desirable because of the high dividend rate Our cash position is such that we could purchase large amounts of preferred stock for retirement over a period of years. But instead of following this course and meanwhile paying 7% on the stock not yet retired, we feel it wise to call the entire issue and replace it with low coupon debentures, with one-to-ten year maturities, to be retired on a definite schedule. The new debentures will, it is expected, be paid out of earnings The company can easily retire the debentures under the proposed schedule of maturities [4]

Conditions here are favorable for the company. It is an operating utility with reasonably stable earnings and a strong financial position Retirement of the bonds is rigidly prescribed In the meantime earnings available for common will be greater.

Adams Express Company elected to retire its 5 per cent cumulative preferred stock in 1935 for the same reason but, instead of issuing bonds, arranged with its banks for a $4,000,000 serial note issue (one-to-five years) at an average interest rate of 2 98 per cent, thus making a substantial reduction in charges senior to the common stock.

Another reason frequently cited for redemption of preferred shares is the group of restrictions burdensome to the corporation and the common stockholders frequently found in the preferred stock contract—cumulative, participating, extensive veto powers over management activities and the threat of preferred stock control if dividends are passed

To Permit Payment of Dividends

Occasionally a corporation may be faced with a statutory prohibition which can be avoided by capital readjustment. A case in point is the

[4] *Commercial and Financial Chronicle*, Aug 24, 1935, p 1286.

General Refractories Company which called a special meeting of stockholders in 1935 to vote on a proposal to reduce the stated value of capital stock by $2,348,531, thus permitting the cancellation of 54,399 shares of treasury stock of an equivalent stated value. The action was to be taken because the Pennsylvania law prohibits the declaration of a dividend by a corporation unless its surplus exceeds the amount of money paid by a corporation for shares held in its treasury.[5] By this action, stated value of capital stock would be reduced and the asset account—treasury stock—to an equal amount, without disturbing the surplus, would be eliminated Without waiting for surplus to be built up through earnings, dividend payments could then be resumed.

Settlement of Senior Dividend Arrearages

Before common stock may receive a dividend, unpaid dividends on cumulative preferred stock must be paid After a long period of poor business, with little or no profit, and dividends passed on all shares, the accumulations on preferred may reach a substantial figure For example, on July 1, 1935, the arrears on the 7 per cent cumulative preferred stock of American Crystal Sugar Company amounted to $2,740,500 or $63 a share. No dividend had been paid thereon for nine years Under such conditions, preferred stock sells for a low price and the common stock of the same company is worth much less than the preferred. Even with the return of better business and profitable operation, until the day when the arrearage on preferred is paid off, the common stockholder must wait for dividends. If the preferred holders can be persuaded to accept some form of security to be issued by the corporation in lieu of cash, thus canceling the accumulated dividends, the market value of their shares will rise as well as that of the common stock which is brought within reach of dividends. The common shareholders usually initiate the plan, which must offer the preferred holders a substantial advantage to win their approval. The usual method is to offer the preferred holders an amount of additional securities, either bonds, new preferred stock, or common stock whose par or stated value exceeds the arrearage The potential income of the preferred holder after the adjustment must be greater than before Such was the plan proposed by the American Crystal Sugar Company mentioned above. Holders of the existing 7 per cent preferred stock were given the right to exchange

[5] *Commercial and Financial Chronicle*, October 5, 1935, p 2276

one share of their stock for one and six-tenths shares of new 6 per cent cumulative preferred with full voting rights, by doing which the old dividend accumulation would be canceled. After exchange, the possible return to the preferred holder would amount to 9 6 per cent per annum on the par value of his old preferred stock as against the 7 per cent payable at the time of making the proposal

McLellan Stores Company, in 1935, solved a similar problem by offering a combination of new preferred and common stock to the existing preferred holders on whose shares unpaid dividends of $21 per share, along with an aggregate sinking fund arrearage of $800,000, had accrued The preferred stockholders received in exchange for each share of 6 per cent preferred stock and accrued dividends, a new share of 6 per cent cumulative preferred and 1½ shares of common. Each share of new preferred was convertible at any time into four shares of common As a further inducement to hasten the conversion of old preferred into new, the company offered the new preferred the opportunity pro rata to exchange 11,693 shares for common at the rate of 7 shares of common for one of preferred, thus reducing the outstanding preferred stock from $4,169,300 to $3,000,000. The plan cleared the way for resumption of dividends on the common stock, which took place shortly thereafter.

Another instance may be cited to show the variety of method used. The National Sewer Pipe Company in 1938 announced a plan for settlement of arrears of $9 per share on its Class A no par stock, as follows In return for the cancellation of stock, plus accrued and unpaid dividends, the holder of each five shares would receive the sum of $130 payable as follows

1. $40 in cash ($8 per share; accrued dividends were $9 per share)
2. $80 principal amount of new 5 per cent convertible, redeemable, 20-year debenture bonds
3. one share of common stock (valued on the basis of the plan at $10)

The company had paid no preferred dividends after December 15, 1933 on its Class A preferred stock, the rate on which was $2 40 per share The Class A holders were thus given cash almost equal to their arrearage, but agreed to accept a future income of $4 interest on the deben-

tures as against $12 dividend on their previous 5 shares of Class A stock. The common stock was of little value to them, since the company announced, when the plan was proposed, that there was little likelihood of any dividend payment within the next few years. In accepting this proposal, although the Class A stockholder suffered a loss in principal, he counterbalanced this with the $40 cash in hand, and a reasonably assured, although reduced income in the future. His additional share of common was speculation.

Readjustment to Extinguish a Deficit

Corporations are in constant danger of losses due either to unprofitable operations which drain away their current assets, or to heavy shrinkage in the value of other assets, either plant account or security holdings. Such losses are generally the result of obsolescence which destroys the value of plant and equipment, or a general depression during which the market prices of securities, especially stock, fall to distress levels If operating losses persist to the point where all surplus is wiped out, a further reduction in assets will impair capital. Under these conditions, either the corporate balance sheet must show a deficit, or some readjustment of liabilities must be made which will more than offset the deficit, and create a surplus. Where the shrinkage in asset value is a market phenomenon, and operations are still profitable, the continuation of dividend payment is jeopardized, for the state statutes generally provide that any dividend paid when capital is impaired or which impairs capital is illegal. Such a condition is undesirable, for the credit of the company is damaged, and prices of its securities are depressed The shareholders, as the chief risk-takers in the enterprise, must bear the burden of the readjustment There are three methods available· (1) by reduction in the number of issued shares, (2) by reducing the par value of shares, or (3) by changing from par to no par value with a new stated value per share sufficiently below the previous par to offset the deficit by changing from no par to par, or by reducing the stated value per share of no par with like effect. The shareholders must of course, if it is to be made, vote in favor of the readjustment. When they have approved it, they have accepted a shrinkage in their equity equal to the amount of the actual or potential deficit.

An illustration of the first method is the readjustment of the capital accounts of the International Mercantile Marine Company in 1929. For

the year 1928 net earnings after depreciation amounted to $1,205,250. The company had outstanding $21,462,000 of 6 per cent bonds, $51,725,000 of preferred stock and $49,781,800 of common. At the close of 1928 there was a deficit of $25,670,122 and accumulated unpaid dividends on the preferred stock amounted to 80 per cent On the other hand the current position of the company was strong, the balance sheet showing $44,678,658 of liquid assets as against $13,009,233 of current liabilities The whole picture, however, was anything but reassuring to the shareholders, either preferred or common. To the latter it was obvious that half of their capital had been lost In addition the large accumulation of dividends on preferred could only mean years of waiting until the deficit was eliminated through earnings (during which time the accumulation would further increase) and the preferred stock dividend accumulation itself was gradually paid off. The outlook appeared to be hopeless for the common stockholders.

The original proposal, approved by 99 per cent of the stockholders, was to give in exchange for each old share of preferred, with all accumulated dividends canceled, one share of new no par preferred and five shares of common. One share of new common was to be given in exchange for five shares of old common, reducing the common stock by 80 per cent This plan was stopped by an injunction obtained on the ground that the property rights of the preferred stcokholders to accumulated dividends were ignored.

The plan finally adopted and put into effect gave $200 in settlement of back dividends and one new share of no par common in exchange for each share of old preferred Each share of old common received one-fifth share of new no par common. Thus preferred stock was entirely eliminated and the former common was reduced by 80 per cent The reduction in capital stock liability eliminated the deficit The settlement with the old preferred stock placed the new common stock closer to dividends than its predecessor had been for years In this instance the reduction in capital stock liability was accomplished by issuing new stock in exchange for the old, and at the same time reducing the number of shares The same result may be attained by stockholder approval of a reduction in par value per share, where existing stock has a par value, as by changing from par to no par, fixing the new stated value per share low enough to eliminate the deficit or, where the existing stock is no

par value, by reducing the stated value per share in sufficient amount.

The particular method used will be governed primarily by the financial plight of the corporation. If the deficit is extreme, and shareholders fully realize their predicament, a reduction in the number of shares is not too difficult to secure. If, as in the case above, there is preferred and common stock and the preferred position is weak, they can be persuaded to accept common stock and the common stock can be reduced. Where the readjustment need not be so drastic, or where there may be difficulty in obtaining stockholder consent, it is preferable to suggest a reduction in par value, or a shift in stated value per share.

Providing a Reserve as an Offset to Assets of Doubtful Value

A frequent reason for voluntary readjustment of capital accounts is the desire by management to provide adequate surplus to absorb anticipated losses in value of certain assets Alert management can foresee that certain losses must be taken in the near future If the loss is to be substantial, it may wipe out the earned surplus and produce a deficit Normal operations may be profitable and company credit sound. If they delay until the loss is taken and surplus disappears, the balance sheet will present an unfavorable appearance, credit may be harmed, and, if a deficit must be set up, dividends may have to be passed, even though profits are currently earned.

Assets of doubtful value commonly involved in such readjustments are (1) Securities whose market prices have severely declined subsequent to purchase, (2) Good-will, (3) Fixed assets or plant whose present value is far below cost less accumulated depreciation, and (4) Deferred assets, such as bond discounts, where the securities have been refunded or retired

The methods usually employed in readjustment for this purpose are the same as those used to extinguish a deficit. The capital stock account is reduced by an amount sufficient to offset the asset shrinkage either by reduction in number of shares, reduction of par value, or adjustment of stated value of no par shares.

The Pennroad Corporation may be used to illustrate a readjustment to offset a severe shrinkage in market value of investment securities. The balance sheet of the company appeared as follows on December 31, 1932

GENERAL BALANCE SHEET

December 31, 1932

Assets	
Cash	$ 347,755 04
Investment Securities at cost	145,679,920 50
Accrued Income	80,426 69
Other Assets	40,300.10
Total Assets	$146,148,402.33

Liabilities	
Notes Payable	$ 400,000 00
Taxes Accrued	545,549 11
Interest and Accounts Payable	916 66
Capital Stock (9,090,000 shares without par value)	90,900,000 00
Surplus	
Capital Surplus	45,241,825 32
Earned Surplus	9,060,111.24
Total Liabilities	$146,148,402 33

The capital stock of the corporation was carried at a stated value per share of $10. The capital surplus was created from the excess of the issue price of the stock over the stated value which was originally $5 per share, later $6.50 per share, and on some shares taken under purchase warrants might have been as high as $9 per share The corporation had been created in 1929 Most of its stock was issued in that year, and the investment securities had been purchased either at the peak of the bull market or shortly prior thereto The stock of the company was held by voting trustees with full voting rights therein for ten years, against which voting trust certificates were issued to the public.

In March, 1933, holders of voting trust certificates received notice that the management had recommended to the voting trustee, who in turn voted favorably, that all shares of stock without par value "be changed to a nominal par value of $1 00 each, thereby reducing the capital represented by the outstanding stock from $90,900,000 ($10 per share) to $9,090,000 ($1.00 per share)." The balance sheet for 1933 incorporated the readjustment and a surplus from Reduction of Capital Stock appeared in the amount of $81,810,000 The notice of March, 1933, gave, as the reasons for the change, reduction in the amount of

federal and state taxes on the transfer of voting trust certificates, and some reduction in franchise taxes which are payable to the state of incorporation annually on the basis of stated capital

An examination of the securities portfolio summarized in the annual reports to certificate holders showed, however, that investment securities had suffered an enormous shrinkage in value On December 31, 1932, securities for which stock exchange quotations were available, which had cost \$51,432,095 80 had an aggregate stock-exchange price of \$5,220,017. Other investments, including stocks, bonds, notes, and advances which had cost \$94,247,824 70 had no stock-exchange quotations at the time, but their sale prices in 1932 would have been substantially lower than cost It is reasonable to infer that the readjustment of the capital account in 1933 contemplated a subsequent absorption of heavy losses in investments, and that it was hoped that these losses could be charged to the surplus so created. Until the end of 1937 this policy had been carried out, and such losses aggregating \$4,189,906 63 had been so charged In 1938, however, the Securities and Exchange Commission prescribed accounting principles for such companies requiring them to charge such losses against net income, and the management was required to transfer the above loss of \$4,189,906.63 from capital surplus to earned surplus

In the annual report to certificate holders for 1938, the management supplemented the explanation given in 1933 for the readjustment as follows

> During the depression the Board of Directors gave serious consideration to adjusting the book values of the securities held by the corporation to accord more nearly with market prices However, incipient recovery made it seem expedient to defer action A recurrence of depression conditions in 1937 and 1938 with consequent sharp reductions in railroad earnings and values has caused the Board of Directors to review this whole subject. After careful analysis the Board has determined that the ledger values of certain investments be reduced from the original cost to figures more nearly reflecting present conditions, although not purporting to represent the amounts which might be realizable on disposition of the securities. Such action does not change the inherent value of the assets of the corporation The basis adopted by the Board of Directors in arriving at the ledger values of certain securities as of December 31st, 1938, is fully set forth in the General Balance Sheet notes and the list of securities which form part of this report The total reduction, amounting to \$87,959,517.95 has been charged against earned

surplus, in accordance with prescribed accounting practice In due time the deficit thus created in Earned Surplus may by action of the Stockholders after May 1, 1939, be charged to Capital Surplus.

To complete the picture, the balance sheet for 1938 is given.

GENERAL BALANCE SHEET

December 31, 1938

ASSETS		
Cash—Demand Deposits		$ 298,881.75
Investments at ledger values, as annexed		
Securities of, and advances to, subsidiaries (Note A)	$ 44,806,797.22	
Other Investments (Note B)	1,938,434 16	
Real Estate—Ground Rents	288,300 00	47,033,531.38
Accrued Income		353,356 87
Other Assets		38,467 86
		$ 47,724,237 87
LIABILITIES		
Taxes Accrued		$ 184,556 70
Accounts Payable		4,960 00
Depreciation Reserve for Furniture and Fixtures		19,925 38
		$ 209,442 08
CAPITAL		
Common Stock (Authorized, issued, and outstanding, 8,300,000 shares, par value $1 00 each)	$ 8,300,000 00	
Capital Surplus	123,948,653 89	
	$132,248,653 89	
Less Cost of Voting Trust Certificates for 140,400 shares of common stock, held in Treasury	264,822.00	131,983,831 89
Deficit Account		84,469,036 10
		$ 47,724,237.87

NOTE A· The ledger values of investments in subsidiaries are based on cost, except as to Pittsburgh & West Virginia Rwy Co. common stock which

is based on published stock exchange quotation December 31, 1938, and Canton Company of Baltimore common stock which is based on the value as indicated by that Company's books of account at December 31, 1938. The ledger values do not purport to represent the amounts which might be realizable on disposition of these securities.

NOTE B The ledger values of "Other Investments" are based on published stock exchange quotations December 31, 1938, except as to Baltimore & Ohio R R Co. convertible 4½% bonds of 1960, which are included in price realized from sale thereof in January, 1939. The ledger values do not purport to represent the amounts which might be realizable on disposition of these securities.

Comparison of the 1932 balance sheet with that for 1938 shows clearly the estimated shrinkage in the value of investments and the readjustment of capital accounts in 1933 provided the means whereby ultimately the losses totaling $92,149,424 58 may be charged against capital surplus.

Good-will, as an asset, may become of doubtful value In the interest of more accurate statement presentation, it should be periodically reduced or entirely eliminated If existing surplus is too small to absorb the loss without creating a deficit, a readjustment is in order. For example the Lima Locomotive Company called a special meeting of stockholders in November, 1935, to vote on a change in capital proposed by the management involving the write-down of good-will from $2,687,716 to a nominal value of $1. Under the plan the capital of the corporation was to be reduced from $10,552,850 to $6,331,710 and the stated value of the no par stock changed from $50 to $30 per share, thus providing a capital surplus of $4,221,140. Against this surplus, $2,687,715 of the good-will account would be charged, leaving a balance to capital surplus of $1,533,424. The company thus had a buffer to absorb the shock of any further asset reduction up to $1,533,424 without another capital readjustment.

One more illustration will show how a variety of adjustments may be made by charges to a capital surplus created by a reduction in capital stock liability In 1934 the Kentucky Utilities Company applied a capital surplus of $6,691,490, together with other surplus and reserves already on the books to the elimination from the company's balance sheet of certain items of abandoned property, appreciation of other assets arising from inter-company transactions prior to 1929, stock discount and expense, bond discount, and expense on issues which had been refunded,

and to the reduction of the book value of certain investments. Thus, at one operation, the management eliminated a number of assets of doubtful value, and reduced others to a more accurate valuation.

To Increase Flexibility of Financial Set-up for Future Financing

A flexible financial set-up is one which permits a corporation, by a variety of methods, to raise additional capital as needed. The advantage of flexibility is that the company can obtain capital from the public through security sales on the most favorable terms A rigid structure, whether fixed by charter and by-laws or through existing contracts with bond or stockholders, makes security sales more difficult.

In 1938, the United States Steel Corporation announced that stockholders would be asked to vote at their annual meeting upon changes in the capital set-up which would give greater flexibility and enable the company to do new financing in the future along any of several lines The chief proposals were (1) to change the common stock from par $100 to no par value, and to increase the authorization from 12,500,000 to 15,000,000 shares, and (2) to authorize the directors to issue bonds and notes convertible into common stock The first proposal would permit the issue of new shares at the best price at which they could be sold, whereas before, they must be sold at par $100 or above. Earnings had been such that steel common had not publicly sold near par value. The second proposal would permit the use of convertibility as an instrument of persuasion to buyers. The management announced that after the par value on common was removed, they would value the outstanding shares at $75 instead of the former par. The reduction in capital would then be used to increase the capital surplus by $217,581,300 to $298,831,321, against which $260,368,520 of intangible assets would be charged, thus reducing that asset account to the nominal figure of $1. The motives for the suggested changes were mixed, with strong indications that, at the time, the main purpose was to write down some assets of doubtful value.

Avoiding Default on Bonds

It will be recalled from the discussion of corporation bonds, particularly that dealing with corporate mortgage, that default occurs when any of the essential covenants of the contract of debt or of security are violated by the borrowing company. The defaults most dangerous to the company are (1) failure to pay interest, (2) failure to pay principal

at maturity, and (3) failure to meet the requirements of the sinking fund Furthermore, most mortgages and deeds of trust provide that, if interest is not paid after elapse of a period of grace following the due date, the principal immediately becomes due and payable This makes default in interest payment serious When the management realizes that default in one of these ways is soon to occur, it takes steps to persuade the bondholders to accept some readjustment plan which will avoid the default.

When default in principal is imminent, the corporation can not satisfactorily refund the bond issue. If interest has been earned and paid, even though the financial condition is weakened, the easiest solution is to ask the bondholders to accept an extension of maturity date Occasionally, the bondholders will accept the offer, with no other change in their contract of debt. The bonds are sent to the trustee and the new maturity date is stamped thereon More often the company must offer the bondholders a *quid pro quo* This may take the form of an increase in interest rate, a premium paid in cash, or both, or a part payment of principal and extension of the balance, the offer depending upon how much persuasion is required For example, the American Beet Sugar Company in 1933 made an offer to holders of $2,885,000 of 6 per cent debentures due February 1, 1935, under which each $1000 bond would receive 20 per cent or $200 in cash and the remaining principal amount of $800 would be extended to February 1, 1940, at the same interest rate. In notifying the bondholders of the proposal, the management stated

> The officers and directors of the company have given careful consideration to the financial position of the company, the general credit and banking facilities open to the company and the uncertainties involved in a refunding issue under the new Federal laws affecting industry and the issuance of securities. Annual current financing for the crop requirements during the last two years has been seriously interfered with by the proximity of the due date of the debentures and the board of directors has, therefore, concluded that it is essential that some action be taken seeking the co-operation of the owners of the debentures for the purpose of preserving their interests as debenture holders and the continued operation of the company.

Here was an offer, made well in advance of maturity date, at the pit of a depression period, when new security flotations were extremely difficult, containing a veiled threat that unless accepted, the bondholders'

position would be damaged. In a few months, the offer had been accepted by a sufficiently large proportion of the bondholders to permit declaring the plan operative.

Another method of avoiding default in principal was that used by the Atlantic Coast Line Railroad to pay the maturity of \$6,500,000 first mortgage bonds of the Savannah, Florida and Western Railway. Their situation was complicated by the fact that two of their own mortgages contained covenants requiring that underlying company bonds be paid off in cash as they matured Funds were insufficient to make the payment The bond market was in such shape that refunding bonds could not be sold at a fair price. The Atlantic Coast Line borrowed \$6,500,000 from a group of New York banks for six months at 4½ per cent, a substantial saving in interest over that paid on the maturing bonds, and the loans were renewable for another six months, with a possible extension for a similar period. The bank loans were secured by pledging \$10,000,000 of 5½ per cent general unified mortgage 50-year bonds of the Atlantic Coast Line, some of which, if the market had been favorable, would have been sold to refund the Savannah, Florida and Western bonds.

A third method used, as an added inducement to persuade bondholders to extend the maturity date of their bonds, is to offer to convert into a superior type of bond. For example, the New York Trap Rock Corporation in 1935 included this provision in its offer to 7 per cent debenture bondholders who were asked, among other things, to approve an extension of the due date of their bonds to avoid default The debentures were given a second mortgage upon the properties of the company already pledged to secure an issue of first-mortgage bonds

Finally, if the financial condition of the company indicates that debt should be eliminated from the financial set-up, bondholders faced with default in principal may be asked to convert into some kind of stock. They are advised that, if bankruptcy reorganization takes place, they will be wiped out, or, at best, their bonds will be converted into stock They may be offered cumulative preferred stock equal to the amount of their bonds, with a dividend rate the same as their former interest rate If the dividend rate is to be reduced, then they may be given a participation in profits above the regular dividend. If the condition of the company is bad, the bondholders may be asked to accept conversion into common stock.

When default in sinking fund payments is the cause of financial embarrassment, corporations, as a rule, do not have much difficulty in persuading bondholders to agree to a modification of the sinking fund covenant. If interest is well covered by earnings, and default in principal is not threatening, the usual procedure is to ask the bondholders to relax the provisions of the sinking fund This was done by the New York Trap Rock Corporation referred to above Interest was being met in spite of a sharp contraction in earnings, but unpaid sinking fund instalments amounted to \$750,000. If they had been paid, working capital would have been seriously impaired The management proposed that all arrears in the sinking fund be waived and that in the future the sinking fund payments be based upon earnings This was agreed to There are few cases on record, where bankruptcy followed default in sinking fund. Bondholders are too happy to receive their interest.

When default in payment of interest is threatened, there are several methods of readjustment available to forestall it Arrangements may be made with a banking syndicate to purchase the coupons which the corporation can not pay, taking company bonds as security, or the bondholders may be asked to accept bonds or stock in lieu of their coupons, or they may be asked to deposit their coupons with some designated agent or trustee, foregoing their claim to interest for a specified period

The first method is least desirable from the viewpoint of the corporation for the bankers must be well compensated for their services. The bondholder receives cash for his interest coupons as usual, while the bankers receive from the corporation an amount of bonds considerably in excess of the cash they have advanced. If the bankers hold the bonds, and interest is paid thereon, they are well rewarded. If later they sell the bonds, they may recover substantially more than the sum of cash advanced to meet the coupons. The corporation has avoided default, to be sure, but they have paid handsomely for the service.

The second method is more frequently encountered Bondholders are notified that the company will not be able to meet the coupons They are given the choice between default, perhaps leading to bankruptcy, and accepting either scrip, bonds, or stock of the company, in payment of their coupons Frequently they choose the latter. When scrip or bonds are so used they may or may not carry interest. If they do, the company is paying interest on interest and if long continued it becomes a heavy burden If stock is accepted, the corporation is relieved of the interest

payment temporarily and the bondholder can sell his shares if he wishes cash. The stock method was used by the Allegheny Corporation in 1934 to avoid default on its collateral trust 5's of 1950, of which there were over $24,500,000 outstanding. The bondholders agreed to accept, in lieu of cash payment of interest on each $1000 bond for five years, five shares of new prior preferred convertible stock having a *dissolution* value of $50 per share The stock was entitled to cumulative dividends of $2 50 per share annually, before any dividend payment on any existing stock. The new preferred also elected two directors of the company, and was convertible at holder's option into 5 shares of common stock. The bondholders were further given the option of exchanging each $1000 bond into 100 shares of common prior to October 1, 1944, or prior to the redemption of the new preferred stock. Thus the corporation was relieved of the payment of $1,225,000 of interest annually for five years, a total of $6,125,000, by increasing the capital stock liability by a like amount The bondholder, accepting the stock, speculated on whether it would pay dividends, and on the market price should he wish to sell. The readjustment, none the less, avoided default at the time.

Complete waiver of interest by the bondholders for a period of time is frequently proposed by corporations under circumstances similar to those above described For example, in 1934, the Denver and Rio Grande Western Railroad offered the holders of its general mortgage 5's of 1955, as a plan to avoid default, half cash for the coupon due in February, 1934, if the two subsequent coupons were deferred to December 31, 1935 The management explained that earnings were poor, and that the company needed the cash for efficient operation and for maintenance.

Occasionally, the bondholders are asked to waive interest for a period of years only to the extent that it is not earned, making any unpaid portion cumulative, any accumulations to be paid off, starting at a fixed future date This is equivalent to asking the bondholders to become income bondholders.

To Eliminate a Mortgage with Serious Restrictive Covenants

It sometimes happens that, in order to sell bonds at a favorable price, a corporation will include in the mortgage deed of trust certain restrictions which serve the purpose and offer no serious difficulty at that time.

Years later, conditions may change, plans for expansion will be made, but the management will be seriously hampered by these covenants in taking advantage of opportunities to finance the growth of the company. When this condition is faced, the best solution is to eliminate the mortgage containing the restrictions In 1934 the Republic Steel Corporation found itself in such a situation and proposed to revamp its capital structure. In 1923 bonds had been sold under a refunding and general mortgage which contained a provision that no dividends could be paid on stocks of the company until all accumulated operating losses incurred after the creation of the mortgage, had been made up. By 1934, as a result of the depression starting in 1930, the corporation was required to make up out of earnings over $29,000,000 before the payment of any preferred dividends, regardless of whether current earnings would permit such payments In addition, accumulated unpaid dividends on existing preferred stock amounted to nearly $14,000,000, with the result that the preferred stock was in bad condition, and any prospect of dividends on common was remote. Republic, at the time, was considering the purchase of the assets and business of Corrigan McKinney Steel Company and control of the Truscon Steel Company, which would require large security flotations or exchanges

The plan proposed by the management was intended to accomplish the following

a. Remove existing obstacles to resumption of dividend payments when earned, by eliminating the refunding and general mortgage.

b. Eliminate the $14,000,000 of accumulated unpaid dividends on existing preferred stock.

c. Provide for creating a new mortgage under which $24,000,000 of new bonds would be sold and part of the proceeds used to retire refunding and general mortgage bonds.

d After retiring the above bonds, permit the repayment of outstanding bank loans, retire underlying debt, and supply adequate working capital for the enlarged enterprise as well as funds for other corporate purposes.

The dividend accumulations were to be paid off by issuing to preferred holders a combination of new convertible preferred and common

stock. Existing preferred stock was to be eliminated by exchange for a reduced amount of the new convertible preferred stock, plus some common stock. The effect of the plan was to rid the company of an awkward mortgage provision, and advance the preferred and common stockholders to a position much closer to the receipt of dividends. The plan went into effect early in 1936, although not all of the old preferred stock was exchanged. Dividends were paid on the new preferred for a time, and a substantial reduction was made in the accumulated dividends on the old preferred still outstanding, although by April, 1939, accumulation of dividends on the former of $6 per share and on the latter of $21 per share had again piled up. No common dividends have been paid since 1930.[6]

To Reduce Market Price of Shares and Broaden Market for Shares

One reason for declaring a stock dividend, and the controlling reason for a stock split-up, is to break up the per-share equity into smaller units and thereby reduce the market price of the stock per share. By doing so a much broader and more active market for the stock may be created. With a larger number of individual shareholders, the market price will not be subject to as violent fluctuations as when the shareholders are few in number, and the unit price is high. These two methods of readjustment were discussed in detail in the chapter on Corporate Surplus and need not be further considered.

To Avoid the Undistributed Profits Tax

The Revenue Act of 1936 imposed heavy taxes upon corporate profits accumulated subsequent to January 1, 1936, which were not distributed to stockholders in dividends but credited to earned surplus account. While this form of taxation has since been eliminated, the administration fought for retention of the principle, and it may again be revived under pressure for an increase in federal tax income.

The Act of 1936 prescribed four methods by which corporations could retain cash or other quick assets and at the same time obtain dividend paid credit or avoid the heavy tax on undistributed profits (1) pay property dividends, (2) pay dividends in company obligations (bonds or notes), (3) pay dividends in stock when such dividends are taxable to the recipient, and (4) pay dividends in stock which are not taxable

[6] Common dividends were resumed in December, 1940

to the stockholder but in connection with which an election is given the stockholder to take cash instead of stock. These exceptions were undoubtedly permitted because, while the corporation itself would avoid the undistributed profits tax, the dividend so declared and paid would be income taxable to the recipient. If the government did not get the tax from one source, it did from another. Property dividends and dividends paid in company obligations have always been taxable income. The Supreme Court held in Koshland v. Helvering that "where a stock dividend gives the stockholder an interest different from that which his stockholdings formerly represented, he receives income" and so is liable for income tax With respect to the fourth method, the law expressly stated that if a dividend is payable at the choice of the stockholder, either in stock which, if distributed without choice on his part, would not be taxable, or in money or property which would be taxable, then the dividend is taxable to all stockholders, even though they elect to take the stock.

Thus some corporations arranged to pay dividends in the form of stock dividends, giving the stockholder an interest different from that which his holdings formerly represented. For example, the Caterpillar Tractor Company in 1936 asked the stockholders to authorize an issue of $25,000,000 of 5 per cent cumulative preferred stock which was to be used for the purpose of paying dividends under the third method described above and so avoid the tax but retain cash in the business. The management so announced the purpose in the call for a special stockholders meeting to vote upon the authorization.

This type of readjustment will be used again by corporations when similar conditions exist.

Readjustments to Comply with the Provisions of the Public Utility Holding Company Act

We have finally to consider readjustments of the capital accounts of public utility holding companies. The Act of 1935 states that "it is hereby declared to be the policy of this title . . . to meet the problems and eliminate the evils connected with public-utility holding companies which are engaged in interstate commerce or in activities which directly affect or burden interstate commerce, and for the purpose of effectuating such policy to compel the simplification of public-utility holding-company systems and the elimination therefrom of properties

detrimental to the proper functioning of such systems, and to provide as soon as practicable for the elimination of public-utility holding companies except as otherwise expressly provided." In order to bring about simplification of holding-company systems and eliminate properties detrimental to the proper functioning of such systems there will have to be extensive and drastic readjustments of the capital accounts of many corporations. In addition, Section 7 of the Act provides that, except for a discretionary power given the Securities and Exchange Commission with respect to refunding issues and other issues whose proceeds are to be used only for financing the issuer's public utility business, only four types of securities may be issued by holding companies after the effective date of the Act (1) Common stock with a par value having no preference as to dividends and having equal voting rights with any outstanding security of the issuer, (2) bonds secured by a first mortgage on the issuer's physical property or secured by first-mortgage bonds of a subsidiary of the issuer, (3) a security which is a guarantee or an assumption of liability on a security of another company, or (4) receiver's and trustee's certificates duly authorized by the court. In other words, no longer may the holding company issue debentures, preferred stocks, or collateral trust bonds secured by stocks of subsidiaries nor may they issue stocks without voting power

It seems clear that when such readjustments are to be made either voluntarily or under commission pressure, the capital structures of such corporations will be drastically overhauled. Some assets will be disposed of and others will be written down in value; some security issues will be eliminated or converted into other types; surpluses will be wiped out or substantially altered, in short, many of the methods of readjustment heretofore discussed will be employed.

One large corporate simplification plan to conform to the Holding Company Act has been approved by the S.E.C., that of the American Water Works and Electric Company. This plan was submitted voluntarily by the company and was generally approved in December, 1937. The plan did not require as drastic readjustments as some others may entail because, with a few minor exceptions, the Commission found that the public utility subsidiaries and other properties controlled, constituted a single integrated public utility system. When its decision was handed down, the S.E.C. reserved jurisdiction to approve or disapprove the amount at which the securities and assets of the constituent com-

panies in the system are carried on the books of such companies. The plan provided for elimination of a number of subsidiaries, so that American Water Works would be left with only three direct subsidiaries which would be combination holding and operating utility companies. Ultimately, new financing was to be done as announced when the plan was submitted, which would, of course, conform to the provisions of the Act governing new security issues of holding companies In the working out of a simplification plan such as this, a variety of readjustments in capital accounts are bound to occur and need not be mentioned here in detail.

A variety of reasons for readjustment of capital accounts of solvent corporations have been presented, together with illustrations of the methods for their accomplishment It is necessary to reemphasize that these manœuvers are proposed by the management to avoid difficulty in one direction or facilitate the attainment of specific aims Intelligent understanding of many corporate problems is impossible by the public administrator or the investing public unless they can relate the cause, the method, and the effect of the changes proposed.

CHAPTER 40

REORGANIZATION WITHOUT BANKRUPTCY

A bankruptcy, followed by creditor's reorganization, is an extraordinary remedy for an extraordinary situation Like a surgical operation, although it may save the life of a distressed corporation, it usually leaves the patient in a weakened condition from which his recovery is slow And for the same reason that intelligent physicians resort to the knife only after all milder measures of treatment have failed, the owners and creditors of a distressed corporation consult their best interests when they unite to tide over the crisis without resorting to the courts.

Objections to the Method of Bankruptcy Reorganization

In recent years, there is a growing conviction among bankers and investors that there is a better method of settling the affairs of an insolvent company than the tedious, costly, and damaging course of procedure required in a bankruptcy reorganization. Not only is a trusteeship costly in money, but it is even more costly in prestige and business reputation There is a general caution in dealing with a company which is in the hands of the courts. Trustees are generally cautious, even timid. Their duty is to conserve assets, pending sale or reorganization They are strictly limited in their expenditures to the money necessary to keep the business alive In some cases circumstances may force the custodian into a policy of vigorous expansion, but these cases are exceptional. The receiver must obtain authority from the court for all unusual expenditures, and the court, knowing nothing about the needs of the business, follows the old rule "When in doubt, do nothing" Even if the trustee is willing to launch an advertising campaign or install improved machinery, or make a long-term contract for material at an advantageous price, he can not count on obtaining authority for this action from the court. The trusteeship is temporary In the mind of the judge, the property is being held for the creditors. If the trustee raises large sums of money, it must be on the security of the property in his possession as an officer of the court. If the expenditure proved unprofitable,

the creditors would bear the loss, and could hardly fail to criticize those responsible The court could not fairly authorize such expenditures, as indicated above, without consulting the creditors, and if the creditors were well advised they would object. Even if they have had a voice in selecting the trustee, they should not favor, save under the most exceptional circumstances, any expansion or rehabilitation program whose cost they might have to pay Such matters are best left to the company which takes over the property after the court surrenders possession. Working-capital loans secured by current assets are sometimes necessary and are not so strongly opposed by creditors.

Serious Damage to the Business Often Results

But while the trustee must follow a cautious, waiting policy—perhaps such a policy, if long continued, is apt to inflict lasting damage upon the business Railroads and other utilities which enjoy monopolistic advantages, over which people must travel and ship, or from which they must buy, can survive a receivership with little permanent damage. Their business suffers, it is true—no monopoly, save perhaps water, is entirely indispensable—but they usually recover But as for manufacturing, financial, and trading companies, a prolonged control by the court is often the road to ruin Their plant deteriorates. Their customers desert them. They lose their position in the market and the public confidence so essential to their prosperity. Many of their best men leave them for more assured employment The inevitable reduction of selling effort in a bankruptcy proceeding, particularly in advertising outlay, weakens their good-will.

The foregoing considerations are powerful arguments, as we have seen, in support of speedy reorganization. They are equally controlling when the question of a receivership or trusteeship is originally considered If it is at all possible to avoid it, bankruptcy should be avoided. The best informed financial opinion is now against this venerable device In place of a bankruptcy, we have two methods of financial salvation (1) the creditors' agreement, and (2) the voluntary reorganization without bankruptcy.

Attitude of Creditors toward an Insolvent Company

The idea prevalent as to the attitude of creditors toward a concern in difficulties is far from correct A man who has advanced money,

goods, or services to a concern is likely to be interested in obtaining a return of the value of what he has advanced. Contrary to common belief, creditors do not instinctively rush into a conspiracy to appropriate their debtors' business They have troubles enough in running their own affairs, without seeking additional worry.

This is especially true of banks. The last thing in the world a bank wishes to do is to take over the business of some one who owes it money If their attitude in dealing with their debtors were strictly acquisitive, the banks would long since have acquired title to a large part of the business property of the country. It is unfortunately true that sometimes no other recourse remains to creditors than to take title to their debtors' property, but they do it only after every other means of obtaining repayment has been exhausted.

In readjusting the affairs of a concern which owes more than it can pay, the adjusters start with certain knowledge of the willingness of creditors to cooperate in any reasonable plan, either of liquidation or of readjustment Liquidation is only resorted to when it is manifestly impossible to put the concern on its feet as a sound and prosperous undertaking

If a brick-making concern, for example, has exhausted the supply of available clay, its creditors will not be interested in a readjustment proposition that involves its continuance in a losing venture The only proposition which will gain their favorable consideration is some plan whereby the ground on which the plant is located can be sold for building purposes The creditors of a wood-working establishment, which is badly located in view of competition and transportation facilities, and which is also of antiquated design, will not listen, if they are well advised, to any proposal to continue the business in its present location On the other hand, a wholesale grocery business which is in difficulties, which has made too liberal use of credit, or whose proprietors have become involved in outside ventures, to the prejudice of their own business, can go to its creditors with a readjustment proposition with hope of success.

Assurances Necessary to Gain Creditors' Cooperation

To obtain the consent of creditors to a friendly reorganization, assurances must be given first, that the enterprise is financially sound, that is, profitable, second, that the management can be changed or con-

trolled, so as to make unlikely a repetition of the mistakes of the past, and third, that the object and method of the reorganization shall be such as to promise the creditors reimbursement within a reasonable time, having regard to the perpetuation and successful conduct of the business. If the creditors are reassured on these points, they will cooperate in working out even a very unpromising situation.

There are certain exceptions to this rule, the most important of which is where the creditors have reason to suspect dishonesty or incapacity on the part of the management. If the creditors lose confidence in the integrity of the responsible head, it is hopeless for him to ask their help. The same holds true of any loss of confidence in his ability. In either event, if the business is to be saved by cooperation of creditors, the man or men responsible for its insolvency, must first resign their positions with the company and eliminate themselves from the situation. With these exceptions, however, it is unusual to find a creditor insisting on the letter of his bond. For instance, in one case, a grocery concern was heavily indebted to certain banks, and owed a much smaller amount of money to trade creditors. The banks, in this instance, having confidence in the honesty and merchandising ability of the owner, went to great lengths in assisting him, going so far as to allow him to pay his trade creditors while extending their own obligations. Starting with this attitude of creditors, which is now general and to be counted upon, we may outline the methods usually employed to readjust the affairs of a business in financial difficulties.

Securing Consent of Creditors to a Realization Agreement

This readjustment is carried out under an agreement, which is called a "creditors' realization agreement." An attorney of high standing is retained; and his retaining fee, liberal though it may be, is the most profitable investment that a business man, in the situation outlined, can make. The attorney sends out letters to all the creditors, inviting them to a meeting, either in his office or in that of one of the creditors enumerated or in a hall hired for the occasion. The creditors attend such a meeting. They have all purchased tickets, sometimes paying high prices, and it is unusual to find many absentees. The meeting is called to order by the attorney, who presents the proposition of his client. He submits, at the same time, an accountant's report, giving the balance sheet and income account of the concern. His proposition is, in effect, as follows

"My client is in difficulties. He owes you gentlemen money which he can not pay. His business is sound if he can be given time and help, particularly time Your security is in that business The value of that business depends on its profits. If you insist upon the letter of your contracts, no alternative is presented except a receivership, and probably bankruptcy. If that is done, and after preferred creditors have been satisfied, little or nothing may be left for the general creditors It is to your interest, therefore, to give favorable consideration to the proposition I am about to make to you

"This proposition is, in effect, that my client will turn his business over to a committee of his creditors. He and his friends hold a controlling interest in the stock. This stock he will assign to the committee named by the creditors. The present directors of the company will resign, and their successors will be named by the committee. If the committee desires to continue the present management because of its familiarity with the business, it may do so. If it desires to replace the present management with outsiders of its own selection, that is within its power. My client stands ready to cooperate in every possible way to make the plan of rehabilitation a success.

"This business may need new capital Its present owners, to the extent of their ability, will cooperate in providing the capital It may be necessary for the creditors to advance the funds needed, either in whole or in part. To secure these advances, they have the entire assets of the business Of necessity, in case the advances are made, existing claims must be subordinated to the obligations evidencing these advances."

The attorney then throws the meeting open to general discussion. His clients are ready to answer any questions. Before calling the meeting, he or his clients have usually taken the wise precaution of conferring with the largest and most influential creditors, and of securing assurances of support for the plan. If possible, arrangements have been made for them to speak promptly and earnestly in support of the plan. A group of creditors is like any other crowd, easily swayed by influential personalities, anxious to stand well with their fellows, and to give the appearance of virtue even if it is absent from their hearts. In the conduct of such a meeting, immediate indorsement of the proposal is essential.

Several brief and emphatic speeches having been made by certain creditors, who, with apparent and most convincing spontaneity, rush to

the front, the question is put "shall the proposed creditors' realization agreement be entered into?" If the plan is honest and sound, if it offers a reasonable prospect that it can be worked out, and if the meeting has been organized in its support in the manner suggested above, it is very unusual that any serious opposition will develop.

A Typical Agreement

An outline of one of these agreements will show the plan and method of this modern form of financial readjustment The situation is briefly set forth in two clauses

1. WHEREAS, The company is largely indebted, but has assets consisting of fixtures, merchandise, stock on hand used in its business, book accounts, cash, good-will etc., which assets if properly handled or administered it is believed will yield more than sufficient to pay in full all the indebtedness of the company;

2. AND WHEREAS, It would be difficult for the company at this time to realize upon said assets unless an extension of time were granted in which for it to pay its existing indebtedness, and unless further moneys were raised to aid in carrying on the business of the company,

Now this agreement witnesseth as follows

1. The capital stock of the company deposited hereunder shall immediately be transferred to the trustees under a voting trust agreement.

2 All the present members of the Board of Directors and the Officers of the company shall at once resign, and their successors shall be named by the trustees named in the Voting Trust Agreement to serve until their successors shall be duly qualified and elected

3 The board of directors shall have the sole power to appoint and remove at will, all the officers of the company, including any general manager, and to manage and direct the company in the conduct of its business, they shall have the sole and exclusive right and power to carry on the business in such manner and for such time as they may see fit, and at any time to discontinue, temporarily or permanently, the whole or any portion thereof, as they may see fit, and, in their discretion, to resume any portion of the business which they may have temporarily discontinued, they shall have the sole and exclusive right and power, at any time, to wind up and liquidate the whole or any portion of the business, to sell the whole or any part of the assets and to distribute the net proceeds pro rata, among its creditors, whenever in their judgment

they may deem such action to be for the best interests of the creditors and stockholders

4. The company shall execute and deliver to each of the creditors who become parties hereto its promissory note in a sum equal to the amount of his claim. Each note shall bear interest at the rate of 6 per cent per annum and shall be payable six months after the date thereof Each of said creditors agrees that his note shall at maturity be renewable by the company for another six months, and at maturity of such renewal the note shall be further renewable for successive periods of six months, for not exceeding two years. In return for these notes, each creditor shall deliver to the company for cancellation all the obligations of the company which he holds.

5. All money borrowed by the company, with interest thereon, and all merchandise purchased by it, together with all costs, charges, and expenses of every kind incurred by it incident to this agreement, shall have priority and precedence in payment out of the assets of the company, so that in any distribution of the assets, these claims shall be fully met and paid before the said assets are applied to the payment of claims of any of the parties to this agreement existing prior to the execution hereof.

6. If, at any time, in the opinion of the board of directors so named by the committee elected by the signatories of this agreement, the best interests of the creditors would be served by a sale of all the assets and business, or by dissolution of the company, they may take such action.

Management by the Creditors' Committee

These represent the important clauses of a typical creditors' realization agreement After favorable action of the creditors' committee, this agreement is signed. The committee is either elected, or preferably named in the resolution (sometimes called a "hand-picked" committee) The stock is turned over to this committee, the directors and officers resign, new directors are elected, and, as a rule, a new manager is appointed, usually to act in connection with the existing management, if, as already stated, the integrity of the present manager has not been called into question.

The business then goes on as before If new cash is required—and that is almost always necessary—banks, which are generally parties to the agreement, advance the money. Their security is a prior claim upon all the assets of the business, including the money they advance The control

and management, being in the hands of the creditors, are ordinarily dominated by the banks, which can therefore safely and properly advance such money as the business may need.

The advice and assistance of the creditors is at the disposal of the committee, especially when these creditors are bankers, it is of great value The mistakes which led to the situation which made the signing of the agreement necessary are corrected Unwise business policies are abandoned, sound methods of management are introduced, and, with ample capital and assured credit, the business is started on the road to recovery.

Reorganization by Creditors' Committee

Operation by creditors' agreement is usually limited to small concerns whose creditors are few, unsecured, and easily called together The capital structure of such a business is usually simple, either a partnership or a private corporation, whose stock, generally of one class, is closely held, and which is managed by its owners The problem confronting a creditors' committee is usually one of overextension of short-term credit The creditors' committee may, it is true, recommend, as a final solution, some form of funding obligations with additional contributions from owners. For example, in 1925, the creditor-selected board of directors of the Standard Tank Car Company, after operating the business for a year, proposed a plan of reorganization involving new money from stockholders, the refunding of certain debts, and part-payment and extension of others There is no reason why any creditors' committee should not insist upon a thoroughgoing capital reorganization as an alternative to forced sale or liquidation Rather than take the chance of a forced sale, which might destroy their interest, owners or stockholders will agree to any fair plan which will give them the opportunity to carry on As a rule, however, the outcome of a creditors' committee control is either the return of the business to its owners, or a liquidation.

Voluntary Reorganization without Foreclosure

We come finally to voluntary reorganization without foreclosure, although a friendly receivership, controlled by the company's organization, is sometimes necessary for protection against recalcitrant creditors. Here the situation is essentially the same—bondholders, some secured by mortgage and some by the general credit of the company, short-term

debt—bank loans and trade creditors, preferred stock and common stock The company can not pay maturing obligations, frequently it is not earning interest on these obligations Banks refuse further credit and press for reduction of loans. Trade creditors are also uneasy and importunate. Under former practice, a receivership and reorganization on familiar lines would be indicated. But if the creditors and stockholders will face the situation, provided only that the business, aside from its unmanageable debts, is sound, they can work out their difficulties.

Basis of Value the Earnings of the Property

It is first necessary to recognize that the property is worth no more than the capitalized value of its earnings. A forced sale will destroy all the equity of the stockholders, and will cut deeply into the value upon which creditors have depended to secure their loans There is no one to buy the property, save some company in the same line of business, and their terms are certain to be hard Holders of underlying bonds may recover their money, but unsecured creditors will join the stockholders in complete loss Cash must be provided, and while stockholders may be persuaded, after a receivership, to pay assessments and take junior securities, this can not be counted on, except in the limited field of public utilities. To the extent that stockholders do not participate, junior creditors must advance the necessary money and go into the sugar, or silk, or cotton-yarn business Beyond this, a long receivership, as we have seen, is expensive and demoralizing Earnings are the basis of a successful reorganization plan and a receivership reduces earnings. Provided only that the different interests concerned can unite in committees, a voluntary reorganization, without foreclosure, is the line of action indicated.

Proposed Reorganization of Cuba Cane Sugar Company

A typical situation is set out in a letter sent to security holders of the Cuba Cane Sugar Company in July, 1929 The situation of the company is set out as follows

> Low prices for raw sugar, restriction of output by Governmental decree, and the generally unfavorable conditions surrounding the Cuban sugar industry during the past three years have adversely affected the operation and earnings of the corporation—net earnings for the fiscal year ended September 30, 1929, are estimated at $3,000,000 before depreciation, interest and income

taxes, as compared with annual interest charges on the present funded debt of approximately $2,600,000 and an annual depreciation appropriation of $750,000.

This unsatisfactory situation, which holds out no prospect for improvement in time to relieve the corporation's present financial difficulties, and which is further accentuated by the proposal for an increase in the tariff rate on Cuban raw sugar, makes it impossible for the corporation to provide funds for the payment of its maturing debentures on January 1, 1930

A receivership, unless co-operation was assured on the part of all security holders to carry through a plan of reorganization, would involve long, protracted and costly proceedings in the Cuban and domestic courts The location of the corporation's property and business in Cuba, which has no law of equity receivership, might, in the event of such a receivership, result in bankruptcy proceedings in Cuba, destruction of property values, and cause entire cessation of the corporation's business for a period of time which would be disastrous Furthermore, such a receivership might extend for a period of years during which time the holders of the existing debentures would probably be deprived of interest or any return on their investment

Under such a receivership, the position of the preferred stockholders would always be uncertain, and their equity in the properties would be seriously jeopardized and possibly entirely wiped out. The satisfaction of the prior claims of the funded debt and of the preferred stock upon which there are unpaid accumulated dividends of 57¾% or $28,875,000 would almost certainly entirely eliminate the equity of the common stockholders in the properties.

The plan of reorganization provides for an adequate extension of the maturing debt and contemplates the possibility that the corporation will have to carry on its operations during some further period of depression in the industry If the plan is consummated, the corporation has assurance satisfactory to the directors of being able to borrow from its banks the amount necessary to continue operations through the season 1929-30 and following seasons unless unforeseen and extraordinarily adverse conditions arise in the industry.

Consummation of the plan will enable the corporation or its successor company to pay the semi-annual interest of 3½% and 4% respectively due January 1, 1939 on the maturing debentures, whereas, in the event of failure of the plan, the corporation will be obliged to default upon the maturing principal of the debentures and of the interest as well.

The provisions of the plan were as follows

1. An exchange of the 7 per cent and 8 per cent debentures for new

6 per cent debentures, interest payable only as earned for five years but to be cumulative

2. The transfer to the debenture holders of 25 per cent of the stock of the new corporation which is to acquire the property of the old company.

3 The sale at $5 per share for the preferred and $7.60 per share for the common to existing stockholders of 1½ shares of new common stock for the preferred stock of the old company, and of 1/5 share of new common stock for the common stock of the old company Option warrants exercisable for ten years to subscribe for new common stock at $20 a share were also offered.

4. Underlying mortgage bonds carrying $660,000 of annual interest remained undisturbed.

The plan contemplated issuing to present stockholders 77 per cent of the common stock of the successor company in exchange for $4,500,000 in cash, and the reduction for 5 years in compulsory interest charges of $1,900,000 annually.

This plan was presented by four committees, the general reorganization committee, and committees representing debenture bondholders and preferred and common stock. It was found impossible to carry it into operation because of the failure of 28 per cent of the debenture bondholders to assent to the plan This was apparently due to apathy and difficulty of communicating with the bondholders rather than to any active dissent or opposition The reorganization committee announced on September 11, 1929, in stating that a receivership was inevitable, that they would attempt to carry out the plan even in receivership and this was eventually accomplished. The preliminary work of the reorganization had already been done, and debenture bondholders hitherto nonassenting were given a further opportunity to deposit their securities

The plan of voluntary reorganization of the Cuba Cane Sugar Company was evidently desirable from the standpoint of every interest concerned. It left undisturbed those bonds whose security was good It gave the debenture bondholders the entire net earnings of the company for five years, which was all they could expect in any event, and it gave them 25 per cent of the stock for their risk of failing to receive interest It gave the stockholders the opportunity to continue 77 per cent of their interest in the properties.

Summary and Conclusion

The attempt of the bankers to make unnecessary a reorganization in the regular form of the Cuba Cane Sugar Company, unsuccessful though it was, shows the prevailing trend in these settlements. It shows a recognition that, irrespective of legal forms, of conveyances of property to trustees, of strong guarantees of interest, of all the well-devised machinery for enforcing the payment of debt, the basis of security is value, and the basis of value is net earnings No creditor can get out of a property a greater sum than the property will yield, and, unless he has been foresighted enough to protect his claim by the physical possession of salable merchandise or securities with a margin over the loan sufficient to take up the loss inseparable from a forced sale, the creditor must be content to take his claim in securities, whose value will depend on the future earnings of the company

If new money is to be provided to pay trustees' expenses or for maintenance or capital outlays, this must come from either stockholders or creditors. If stockholders have no equity in the property of the bankrupt company, under recent court and commissions ruling, they are not considered. If there is some value for the stock, however, they may be asked to contribute. This is no longer, under the new practice, obligatory upon the stockholders. In former days, they were immediately threatened with foreclosure if they did not furnish new money by buying securities in a new company which took over the property after a judicial sale To-day, as already shown, the stockholder may still be threatened by creditors that they will not approve the plan unless the stockholder coöperates In that case the plan fails and the property may be sold The former offer to stockholders took the form of an "assessment" upon the stockholder. If he paid $5 or $10 per share, on his full-paid stock, he was offered an equal amount of stock of equal rank in the new company. If he did not pay, he was eliminated as a *nonassenting* or *defaulting* stockholder and the stock which he was offered passed to bankers who had underwritten his assessments This method of coercion has long since passed away. It was based on a falsehood The holder of full-paid stock has no obligation to pay. He can not legally be assessed These "assessment" offers were in reality offers to subscribe to stock in a new company. Before the World War, the practice of "assessment" had been discarded. The stockholders were now asked to buy new stock

in order to preserve the value of the interest in the company with the threat of creditors' sale to back up the request.

An excellent illustration of such an offer was that made to the owners of Westinghouse as early as 1908 when the "assessment" approach was still prevalent.

Proposition to Westinghouse Stockholders

This was the proposition which, in substance, was made to the stockholders of the Westinghouse Electric and Manufacturing Company, on April 8, 1908. The stockholders' committee of this company sent out a circular letter outlining a plan of reorganization in substance as follows Certain bonds of the company were to remain undisturbed The floating debt was in part to be converted into stock and in part funded into bonds and notes. The stockholders were to subscribe at par for $6,000,000 of new stock The proposition to the stockholders was as follows

The chief difficulty with the company and the principal cause of the receivership are found in the fact that, as the result of the rapid expansion of its business, too large a proportion of its investment is represented by debt If a substantial reduction can be made in the debt by the sale of additional stock, it is believed that the receivership can be promptly terminated with every prospect of the company entering upon a career of renewed prosperity. On this point the reorganization committee said

"The committee believe that if the conduct of the business can promptly be restored to the stockholders under the direction of a strong board of directors, the company will continue to make substantial earnings On the other hand, there can be no doubt that a continuation of the receivership for a considerable time, and a forced liquidation of the assets, would be disastrous to the creditors as well as to the stockholders"

The Merchandise Creditors' Committee have shown their confidence in the company and its future by undertaking to secure the exchange of, at least, $4,000,000 of the company's floating debt for "assenting stock," at par They, however, impose the condition that the remaining $6,000,000 of the $10,000,000 of subscriptions required to terminate the receivership and place the company in a safe position shall be furnished by the stockholders It is for the purpose of securing from stockholders subscription to this $6,000,000 of stock that the undersigned committee has been formed

The holders of the preferred and common stock of the company are, therefore, asked to subscribe for "assenting stock" of the company at par, at the rate of at least one share of new stock for every four shares (or

fraction thereof) of existing stock. Such subscriptions are to be payable in the following installments

25 per cent on May 25, 1908,
20 per cent on August 1, 1908,
20 per cent on November 1, 1908,
20 per cent on January 1, 1909,
15 per cent on April 1, 1909

The deferred payments are to bear interest at the rate of six per cent per annum, with the privilege to subscribers to pay their subscriptions in full at any time

The Merchandise Creditors' plan cannot be carried into effect unless the stockholders protect themselves by subscribing pro rata for their shares of this new stock. If these subscriptions are not forthcoming, the inevitable result will be that the Readjustment Committee, which was organized for the protection of creditors, will be forced to reduce the debt of the company to judgment, bring about a forced sale of the property and its acquisition by a new corporation organized in the interest of creditors Such a course would result in enormous loss which would fall chiefly upon the stockholders of the company That loss can be avoided only by the cooperation of stockholders in promptly subscribing for a sufficient amount of new stock to insure an early termination of the receivership.

The committee wishes to lay special emphasis upon the fact that the success of this plan for saving the company for its stockholders requires the unanimous compliance of stockholders, however small their holdings, with this request for subscriptions The ownership of the stock of the company is divided among about 4,000 stockholders, the average holding (excluding the holdings of the Security Investment Company and its president) being only about eighty-three shares (par value, $50) Most of the stock owned by the Security Investment Company has been pledged as collateral in comparatively small amounts with a large number of banks which are being asked to subscribe to the new stock in proportion to their respective holdings

Subscriptions to the stock of the Westinghouse Electric and Manufacturing Company were largely influenced by this express threat that failure to procure the required amount would subject the stockholders to the danger of foreclosure sale.

The situation of the Westinghouse Electric and Manufacturing Company was, however, different from that of most bankrupt corporations. With this company, the trouble was chiefly due to inadequate working capital which resulted in an excessive amount of floating debt calling for

the payment of both principal and interest at a time when financing could not be done The reorganization of the Westinghouse Company required nothing more than the funding of this current debt on which the company was abundantly able to pay interest. The stockholders' interest in the property was plain Even during the receivership, the stock never fell below \$8.75 (par \$50), which indicated a considerable margin of value after the debts were paid.

CHAPTER 41

CONDITIONS PRELIMINARY TO CORPORATE REORGANIZATION

The reorganization of insolvent corporations is a financial process undertaken after default has occurred, or when it is impending. A study of plans for the reorganization of corporations disclosed that many make provision for the participation of one or more issues of bonds in the new arrangement of the capitalization This implies that, prior to reorganization rearrangements, bonded indebtedness was outstanding A business may also be inconvenienced by secured or unsecured general debt When the amount of this debt gets so large that it becomes necessary for the management or creditors to seek relief, their efforts often take the form of voluntary or involuntary bankruptcy proceedings Since taking actions of this kind, where bonds are outstanding, is an event of default, they would be included in a discussion of the causes of corporation bond default

Nature of Default

Default is a term used to identify failure. The issuing of bonds by a corporation involves a variety of promises to bondholders. These promises are contained in both the bonds and the agreements which supplement them The prospect of carrying out these obligations is always uncertain Any such failure, continuing to the point where the bondholders or their trustees are entitled to avail themselves of the remedies provided for such emergencies, constitutes default.

Debt as a Factor

Most, but not all, of these promises provide for expenditures of money. Inability to make such outlays endangers the achievement of the primary purpose underlying all business enterprise, namely, its continued existence as a going concern. Failures which amount to default will not happen if a corporation can obtain the funds needed to pay its debts. This

fact is the basis for classifying default as a financial and not a legal problem, as some seem prone to consider it The legal formalities and procedures pertaining to a situation of breach of contract by a corporation may be necessary to interpret events in terms of the violated agreements If, however, default has not occurred, it can not be induced, nor can its existence be established through legal processes

Whenever a corporation bond is defaulted, the conditions responsible for the situation are generally confined to the non-payment of the principal when due, failure to meet sinking fund payments, or the failure to pay interest. These debts, fixed charges—are distinguished from other debts because they result directly from an issue of bonds. In a majority of cases, a statement that default was caused by the non-payment of bond and note charges would be correct But other debt incurred in the course of company operation also figures in the problem. The non-payment of any obligations of this kind results in an event of default The entire debt of a corporation then becomes due and payable When contemplating the nature of corporation bond default, it is important to give consideration to debt of every kind instead of only bonded indebtedness

Income as a Factor

The other side of the question of default has to do with the funds of the company, because the payment of indebtedness depends upon the funds received and available for this purpose. The sources of funds are more or less familiar. Access to the sources varies according to different industries, the individual enterprises operating within particular industries, the means whereby funds are acquired, and the methods employed in their acquisition

The pattern followed by corporations in obtaining funds is to dispose of and receive payment for shares of capital stock, properly authorized secured or unsecured evidences of debt, such as bonds, notes, commercial paper, fixed capital assets, miscellaneous current assets, and goods and services which they produce The selection of any one of these devices is influenced by a factor common to all business enterprises, namely, the gross income. Without current profits it is difficult to sell notes or shares of stock, although a company showing past profits may secure funds on the basis of this record The investor may have sufficient faith in the future to ignore the deficits of the recent past Generally speaking, how-

ever, a good showing of average profits by a company—three to five years, is necessary if the investor is to buy its securities

Certain limitations and restrictions may be encountered in connection with the use of bonds These obstacles take the form of provisions contained in the mortgage deed of trust or indenture supplementing the bond issue. They prescribe the conditions under which bonds may be issued Unless such covenants are complied with, bonds can not be issued and sold, in which case, a refunding issue must be offered to obtain funds. In getting funds through a refunding operation, the amount of refunding bonds issued must exceed the amount of bonds refunded.[1]

In the absence of gross income, the marketing of short-term notes or discounting of paper at commercial banks can not be relied upon as a means of obtaining funds The sale of property or securities are available only when sales will not interfere with the efficient operation of the business.

A corporation must depend for its supply of funds upon the receipts from the sale of goods and services Theoretically, all of its assets are available to pay its debts, but such sale or hypothecation, without current income derived from earnings, within a short time, will lead to default. A company may meet interest and maturing obligations by depleting its current assets, accumulating current obligations, and reducing maintenance, but this is the road to ruin

Immediate Causes of Default

Failure to pay either the fixed charges, or general and unsecured debts, or both, is the immediate cause of default This can not be considered, however, as the real cause Underlying these non-payments, are to be found events and actions which have made it impossible for the corporation to maintain a proper relationship between its total gross income and the total of its debts These more fundamental events and actions are in reality responsible for the shortage of the funds. They are, therefore, the real causes of default.

Alleged Causes of Default

Whenever defaulting corporations have obtained a large part of their capital by bond issues, or when they are public utility companies whose

[1] See *supra*, Chapter 39

operations are "affected with a public interest" investigations are usually made by experts employed for the purpose, bondholders', creditors', and stockholders' protective committees, or trustees under the mortgages and indentures; or officers or directors of the company The reports of these experts or groups often mention the events considered responsible for the default These alleged causes of default must be subjected to analysis, before they can be accepted

1. *Accumulation of Bank Loans.* The ability to repay funds which have been borrowed from banks depends upon the use which has been made of them The basic rule justifying the practice of borrowing from banks, is that funds so acquired shall be used only in self-liquidating transactions This rule is violated when borrowed funds are used to pay interest on bonds, or to continue unprofitable operations Even in instances where a company obtains funds from bank loans to finance the process of manufacturing, it is not warranted in accumulating inventories of finished goods which can not be conveniently liquidated Bank loans should not be invested in slow assets or assets which are liable to sudden depreciation in market value

2. *Advancement of Capital to Other Companies* A variety of reasons may cause one corporation to advance capital to another. The Alaska Anthracite Railroad, "made advances of capital to coal companies whose coal it was to haul, which coal companies were underfinanced, whereas the railroad company needed it and should have returned to its own exchequer the capital which it financed" The Distillery Securities Corporation defaulted on its bonds in 1922 because the company of which it was a subsidiary, in attempting to develop other food enterprises and export trade in food products, diverted capital from the company under the guise of advances. Default resulted. A corporation may default because of advancing capital to other companies, when the amount used in this direction is so great that its own obligations can not be taken up, or the company receiving the advanced capital can not make repayment

3. *Assumption of Obligations of Other Companies* The assumption of obligations was advanced as a cause of default in the instance of the Denver and Rio Grande Railroad Company failing in the payment of interest on $31,114,000 of its outstanding bonds, due Feb. 1, 1922. After making an investigation, the Interstate Commerce Commission concluded that default was occasioned by the assumption of

obligations with respect to the Western Pacific and its securities, which were beyond their abilities to fulfil.

4 *Cost of Financing* The cost of financing a corporation depends upon the rate of return demanded by the investor and the method adopted to distribute the securities The rate is determined by the type of security which is offered, and the supply of and demand for funds available for long-term investment. The rate demanded by lenders on long-term investments fluctuates from time to time, since the factors affecting the supply of and demand for funds are not constant. A particular corporation can bring no influence to bear upon the rate prevailing in the market, at the time it proposes to finance itself However, the cost of financing can not become a cause of default until after the financial transaction has been completed Even then, the cost becomes a burden only in case the financing is undertaken at a time when the demanded rate is comparatively high.

5. *Delay in Collecting Outstanding Accounts* The financial embarrassment of the Downey Shipbuilding Corporation was explained by delays in making collections of large outstanding accounts Included in the accounts was considerable money due the company on government contracts. In dealing with government departments it is necessary for the contractor to be sure that an appropriation covers the outlay Otherwise a special Act of Congress is necessary to authorize the payment Many distressing and even ruinous delays have resulted from failure to observe this rule The receivership of the Mason Tire and Rubber Company was "more immediately precipitated by the tightening of the money market and the delay in collections at a time when the company's capital was somewhat impaired " Delay by a corporation in collecting amounts which are due is a matter for which the credit department of the company must assume responsibility

6 *Excessive Inventories and Excessive Trade Liabilities* In anticipation of default on its bonds, a statement issued by the directors of the Mattagami Pulp and Paper Company, Ltd , mentioned that "in the ordinary course it has incurred trade liabilities which, if business had been normal, would have been easily liquidated, but some of these creditors have been pressing for payment and have threatened to take legal proceedings Under ordinary circumstances, the company's current situation would not be serious, and its trade liabilities would have been met without difficulty out of current operations. However, the

market for the company's product has been such that the company is temporarily unable to turn its inventories into cash." The management of the Moline Plow Company, "found themselves during the closing months of 1920 with a large and slowly moving inventory," and the Republic Motor Truck Company, discovered that "the business situation did not permit of liquidation of inventories as was expected."

7. *Expansion.* The expansion of business enterprises is one of the reasons for default most frequently offered. Corporations generally expand by purchasing the materials necessary to construct the added property, by acquiring a controlling interest in the stocks of other companies possessing the essential property, or by entering into an operating lease agreement with a subsidiary or an independent company.

The use of the method first mentioned often requires that a company incur debt. The necessary labor and materials are purchased on open account. By these transactions, general and unsecured debts are originated. They are presumed to be payable out of the current assets. This is also true in instances where the expansion is being effected through purchases of controlling interests in stocks of other companies. The stocks are purchased either on the various exchanges or outside of them, and to the extent that they involve payments in cash, current assets are reduced. The amount of such assets, at any given time, is composed of that part of the proceeds of former sales of securities, and that part of past income withheld from distribution by the management, which has not taken the form of fixed assets. Provided the excess of current assets of a corporation is large enough to allow the reduction incident to the payment of these debts, default can not come from expansion so financed.

Not all corporations find it possible to maintain their current asset position at a level which permits the payment of debts caused by the day-to-day conduct of their affairs and, at the same time, pay the obligations coming from extensive programs of expansion. The use of current assets for the latter purpose is usually a temporary action taken in anticipation of permanently financing the expansion through the sale of stocks or bonds at a later date. When plans of this kind fail, the result is a lack of working capital, which has been given as a cause of default and is discussed under that title.

Whenever securities are sold, after the expansion is under way and partly completed, and the proceeds are used to replenish current assets

and provide funds to complete the undertaking, the payment of the debts due to the expansion is made possible by the use of securities. The financing of expansion is also accomplished by using securities, when the required materials or controlling interests in stocks of companies are acquired by a direct exchange of securities, either stocks or bonds Stock issues so made present no problem

When bonds are issued for expansion purposes, if the amount of such indebtedness is to cause default, it must be so great as to create a burden of fixed charges which, together with general and unsecured debt, will exceed the gross income. The total fixed-charge debt may be increased when an operating lease agreement is used in expanding a business The rental which the lessee company is obliged to pay to the lessor for the use of the property is considered a fixed charge, and its influence is determined by its amount

When examined from the income side of the problem, the effect of expansion can only be estimated No matter how accurately these estimates are made, it remains for the future to reveal how nearly correctly they predicted subsequent conditions It is customary to justify the expansion of a corporation on the assumption that expansion will increase the total *gross income* or prevent its reduction These objectives are to be brought about by lowering costs of production so that larger quantities may be sold at lower prices, by increasing the volume of production and sales without a change in price, and by eliminating competing enterprises and so stabilizing selling-prices Sometimes, after the expansion is completed, it develops that costs can not be sufficiently lowered, sales volume sufficiently increased, or the selling price stabilized, to produce the favorable change in total gross income anticipated. It is the conditions responsible for the non-realization of these objectives that are the causes of default, and not expansion Some of these conditions, pertaining to the affairs of a defaulting company, appear in the following statements

"The Western Pacific railroad traversed a mountainous and desert country which was utterly unable to contribute any substantial amount of traffic and, that ample traffic facilities already existed for traffic moving between the Pacific coast and all territory east of the Rocky Mountains," or

"The present position is due to commitments for construction, and other expenditures have been undertaken before adequate financial ar-

rangements were made . . . the construction expenditures on the Kipawa plant having exceeded the original estimate of cost . . ." or

"The immediate requirements were for meeting on January 1, obligations for about $2,000,000 and this would have been obtained. But to complete the construction and equipment work now under contract and to provide for additional expenditures for similar purposes during the coming year, will require the raising of many millions more, and the general situation affecting street railways, with the stationary fares and rising costs has injured their credit and made impossible up to the present provision for the investment of fresh capital"

"The Company has been greatly handicapped by the delay of the city in completion of its subways. They should have been mostly in operation two years ago The essential parts of them are still under construction. In the meantime a large part of our $60,000,000 investment is unproductive and existing and completed parts cannot be effectively operated"

"The Converse Rubber Shoe Company, ventured into the tire business, and as a result, losses of $1,700,000 were sustained Early in 1924 it was estimated by a leading authority on industrial affairs, that there existed a manufacturing capacity of 100,000,000 tires a year and a consumption of about 40,000,000 tires. This condition of the tire industry probably accounted in part for the failure of the experiment of the Converse Rubber Shoe Company, culminating in default on its bonds"

8. *High Royalties Payable.* The agreements resulting in an obligation to pay royalties are usually in the form of leases The royalty burden may be onerous from its inception, or it may be assumed when prices are high and under subsequently changing conditions, become too great a load

The terms of a lease agreement providing for royalties are the outcome of negotiations between the owner of the involved property right and the proposed beneficiary. At the time an agreement is entered into, both parties should know whether or not the conditions under which the conveyed right is to be exercised are permanent or changing, and that it is possible to draw an agreement which will provide that the amount of royalty to be paid should change with conditions.

9. *Inadequate Maintenance of Property.* The importance of maintenance as a factor in the financial management of a business enterprise has been previously explained.[3] The result of inadequate maintenance

[3] *Supra,* Chapter 26

is shown in a letter by the Receiver of the American Writing Paper Co to the Bondholders' Protective Committee as follows

"The physical examination of the plants was made by two men having experience with other companies of approximately twenty years, and showed that over half of the plants were so out-of-condition that it would require a minimum expenditure of $800,000 to put them in a condition in which the necessary quality of paper to compete successfully with other companies could be produced For really efficient production a substantially larger amount should be expended in rehabilitating the plants" When the physical property of a corporation is not maintained up to a standard which allows its efficient operation, the result is a high production cost or an inferior product.

10. *Lack of Working Capital.* The generally accepted concept of working capital *owned* by a corporation defines it as the excess of current assets over current liabilities. It is also that part of a company's capital used to pay its debts. Accordingly, it is not only essential that there be an excess of current assets, but these assets should be in forms making them available for satisfying creditors In other words, they should be liquid, readily convertible into cash. Sound business practice prescribes that working capital be used in transactions which return at least the *amount* used and, if possible, a profit. Thus, the activities of the business continue undisturbed, and the claims of creditors are liquidated. However, the fixed charges and general and unsecured debts of a corporation can not usually be discharged by making payments in raw materials, finished products, or accounts receivable, although they represent a part of its working capital. From the viewpoint of corporate default, therefore, lack of working capital is lack of cash

The reasons given by some companies for a lack of cash with its resultant default on bonds, are failure to provide an adequate amount at the beginning of the enterprise, the investment of an excessive amount of cash in fixed capital assets, the investment of an excessive amount of cash in inventories, inability of the corporation to sell securities due to restrictive provisions included in mortgages, deed of trust, or indentures relating to outstanding debt, and the unprofitability of business operation. The first of these reasons is a managerial error, the second and third represent violations of conservative business principles by the management. Furthermore, the provisions included in the agreements

supplementing bonds are approved by management Where the business is unprofitable, it is this condition, rather than the lack of working capital, which causes the default

11. *Losses on Sales of Fixed Capital Assets.* The land, buildings, and equipment of a corporation usually make up most of its fixed assets To take a loss on the sale of any of these assets, the corporation must receive an amount below their book value This does not mean that the amount received is below the price paid for the disposed-of assets, because book value gives consideration to the amount of depreciation which is set aside to take care of loss in asset values In case the proper amount of depreciation has been provided for, such amount, together with the sales price received for the property, will be equal to its cost, and a loss would not result from the sale. It is plain, therefore, that inadequate depreciation may cause such losses Because the policy of a corporation in this matter is determined by the management, their decisions would be responsible for the outcome

The depreciation pattern used in different fields of business activity, is rapidly becoming standardized. Consequently, it would seem that losses suffered through the selling of fixed assets, would be an acceptable cause of default, provided the management of the company had complied with the standards adopted in the particular industry However, the problem of depreciation is only a part of a larger problem, the sale of the fixed capital assets The officers and directors of a corporation usually decide which property is to be sold. They determine the time when the sale is to be negotiated and agree upon the price to be received in exchange for the property

12. *Manufacturing Difficulties.* The defaulting Dryden Paper Company, Ltd, experienced manufacturing difficulties in the form of the failure of a new wrapping-paper machine. In the case of the American Chicle Company this cause was mentioned but the nature of the difficulties does not appear The processes of manufacture, raw materials used, selection of the mechanical equipment employed in producing the goods or services, are decided by the management.

13. *Overcapitalization* Within certain broad limits, corporations enjoy freedom in matters concerning their capitalization The pattern of capitalization is fixed by the general incorporation laws of the several states, and sometimes is subject to the approval of a governmental supervisory body In using this privilege, a point may be reached by a

corporation where it is overcapitalized, and this condition has been advanced as a cause of default.

The most generally approved idea of overcapitalization refers to a condition in which the face or par value of the shares of stock and the bonds issued by a corporation, exceeds the fair value of its property, including good-will, patents, franchises, and other forms of intangible wealth. If this is correct, it is apparent that a corporation may be overcapitalized without taking on the risk of default This is true, if the capitalization consists exclusively of preferred and common stocks, since there are no fixed charges and default is impossible. Only when the excess amount of capitalization is represented by bonds or other evidences of debt, with their outgrowing fixed charges, may overcapitalization result in default

14. *Payment of High Prices for Property.* The price which a business pays for property purchased is determined by the operating of economic forces reflected in the demand for, and the supply of the property, at a given time in a given market Included among these forces is the bidding, one against the other, by prospective users of the property The presumption is that ownership of the property is desired for its ability to produce earnings The bid price is based upon the potential earning power. Estimates of the prospective earning power of the property are made by those in control of the bidding corporations. But what is the inference contained in the alleged cause of default under discussion? It can only refer to a condition where the earnings a corporation expected to obtain by owning certain property, and which furnish the basis for the price paid by the company for the property, did not materialize

15. *Underfinancing* Only slight consideration is needed to establish the status of underfinancing a corporation as a cause of default. The amount of capital which is provided to conduct a business enterprise is fixed by the management. If subsequent developments prove its insufficiency, the decisions of the management are responsible for any resulting default

The conditions, financial and otherwise, suggested as causes of default, and considered in the discussion, can not be accepted at face value. Completely analyzed, they are shown to be events and actions arising out of decisions made by those in control of corporations When default occurs as a consequence of these happenings, it does so because judg-

ments have not proven effective. Grouped as a class under the title, *ineffective management*, they more accurately present the facts and as such, merit recognition as a real cause of default.

Real Causes of Default

A continuation of the analysis permits the formation of a second group of causes of default The items in this group include events and actions which are, as named, causes of default independent of managerial judgment. This is plainly the case with the following

Adverse Decisions by Courts or Commissions, Passage of Laws, General, Industrial and Local Business Depressions, Hostile Public Attitude, Abrogation of Contracts by a Receiver, War, Failure of Associated Companies, Default in Payment of Rentals by Lessee, Termination of a Lease, Unfavorable Rates and Fares and Lack of Traffic However, with other conditions, such as, Competition, Obsolescence, Inability to Obtain Fixed Capital, and Inability to Refund Maturing Bonds, the lack of management influence prevails, although less readily observed than in the cases previously mentioned. This position is made clear by the following descriptions of them.

1 *Competition* "Competition is the life of trade," has long been quoted as a business principle Its importance must go unquestioned where it is responsible for improvements in business equipment, methods, and practices On the other hand, it has been proposed more often than any other factor as a cause of default.

Competition may assume a variety of forms and arise from many different sources, yet, in so far as default is concerned, its result is the same in practically all cases, that is, a reduced corporate income. Although competition in rates charged by railroads has been practically eliminated, and competition based on price within particular manufacturing and trading industries, has been checked by activities of trade associations, the purchase of one good or service in preference to another good or service which may be substituted and produced by a competing corporation, is mainly a question of price Therefore competition usually takes the form of price-cutting

The lowering of the price by one corporation operating in an industry forces others selling in the same market, either to meet the lowered price or refuse to do so All other factors remaining undisturbed, if the price is lowered, the volume of business will likely be

retained. If it is not lowered, it will be reduced Assuming the lowered price to be below the production cost of companies charging the higher price, retention of business volume will not prevent reduction of their total gross income, and loss of business volume will have the same effect How can one producer sell its product, of equal quality to that of competitors, at lower prices, and make an equal or greater profit per unit of output? The answer is that the corporation charging the lower price enjoys differential advantages over its competitor in production or distribution. These may be the outgrowth of the control of sources of raw material, the use of more modern and efficient equipment, the payment of a lower wage-scale for a similar quality of labor, a more effective purchasing or selling policy, lower cost of capital, nearness to market, lower freight rates, lower taxes, or the economies of large-scale production, etc Whenever a corporation suffers a total gross income reduction to the point of insolvency, because a competing concern has supplied its market with the same goods or services at a lower price, it is the lack of differential advantages which causes the default A corporation subjected to destructive competition has no control over its competitor's affairs The situation can not be corrected and competition is the cause of default.

2. *Obsolescence* Obsolescence is a condition which is often confused with competition It was proposed as a cause of default in 1894 by Simon Sterne when analyzing the reasons for the failure of railroads Suggested among other causes was, "the necessity of physically rebuilding a new railroad as its traffic develops and the increase in funded and floating debt incurred " The concept of obsolescence has since been broadened and its application is no longer confined to units of physical property used by corporations It has been extended to include the condition of out-of-dateness of goods or services produced

Obsolescence of a corporation's physical property is brought about by persistent improvement of the arts This is due to the struggle by corporations for profits and makes its appearance in the development of technically superior and more efficient equipment The influence of obsolescence on the total gross income of a company is manifested in the following manner, under conditions of free competition In any industry, a corporation possessing equipment with maximum operating efficiency is in a position to dominate. Others, operating within the industry and wishing to continue profitable operation must, in so far

as it can be done, similarly equip themselves in order to effectively compete The acquisition of the more efficient machinery necessary to do this, is not for the purpose of extending the activities of the business, but instead, to enable it to retain the position already achieved If re-equipment is impossible, the present property will, in time, become antiquated to the point where production costs will be too high to allow sale of the product at a price above cost Total gross income will decline so that debts can not be paid.

The influence of obsolescence as a cause of default may also appear in the total fixed charge and general and unsecured debts of a corporation, when the obsolete property is replaced by more modern and efficient items, depending upon the method used to finance the purchase of the new property The effects of using different methods of finance were described under the subject of "expansion." They do not differ when the newly acquired property replaces that which has become obsolete. It should be kept in mind, however, with respect to obsolescence, that the new property is primarily essential to conserving rather than increasing the total gross income of a corporation

The same line of reasoning applies when obsolescence occurs because the product or service is no longer demanded by the consumer While there is a marked difference between the two forms of obsolescence, in so far as default is concerned, this difference appears to be one of approaching a common problem from two different viewpoints.

Obsolescence of the physical property of a corporation, as a cause of default, assumes that high production costs prevent the corporation from meeting the demands of the consumer at existing market prices. Considered in connection with the product or service, the assumption is that consumer's demand for the product or service at any market price above prime costs, does not exist.

The correction of either of these conditions requires replacement of a corporation's property or equipment. In no other manner can the production cost be reduced to meet the market price, or a new product or service produced to meet the existing consumer's demand. When one competing company possesses a monopoly based upon more efficient equipment or a wanted product or service, the difficulty of preventing default is increased. Aside from the question of monopoly, since one corporation can not prevent another from inventing new equipment, discovering

new processes, or engaging in the production of goods or services, obsolescence is a real cause of default.

3. *Inability to Obtain Additional Fixed Capital and to Refund Maturing Bonds* Inability to obtain additional fixed capital as a cause of default is mentioned in statements as follows

"It has become obvious that the Company at no time has had sufficient authorized bonds which it could sell to meet capital requirements for expansion of its business "

"For about a year a few directors and large stockholders have been advancing for development and other purposes such moneys as were required but they are not in a position and can not be expected to carry the whole burden "

"Financial conditions during the past few years have been such that the subsidiary companies have been unable to sell any securities for needed requirements Certain capital expenditures have been compulsory, and the floating debt of the controlled companies has been increased."

"The properties of the Company are capable of producing well prepared coal at reasonable production costs. They need new capital in order to provide such cost reducing equipment as is practical, and more of the facilities for making that quality of product called for by present day demands "

Each of these statements indicates that additional fixed capital was desired for the purpose of expanding the property of the enterprise, presumably so that total gross income would be increased.

Inability to obtain additional fixed capital because of an insufficient amount of authorized bonds comes from decisions of the management in fixing the amount of bonds to be issued originally, or providing for subsequent issues in the covenants included in the mortgage deed of trust or indenture supplementing the bonds. However, in a majority of cases, due to lack of demand, corporations are confronted with conditions adverse to the sale of their securities Inasmuch as investors can not be forced to buy corporate securities, the inability to obtain additional fixed capital is a cause of default largely independent of decisions of management.

Although criticism may be aimed at the management of a corporation failing to make provision for amortizing its bonded indebtedness, when

the bonds mature and they can not be refunded, the situation is very much like that involved in the selling of securities above described.

4 *Dependent Causes of Default.* Another group of named causes of default includes those which may or may not be accepted as such, depending upon the existence or non-existence of certain significant conditions. They are listed as, Calamities, Decreases in Sales, High Operating and Production Costs, Operating Losses, and Strikes, and will be described in this order.

Calamities

A calamity may take one of a great variety of forms. The following have been held to be partly or entirely responsible for corporate default a severe drought in the tropics, the destruction of a bridge by fire, the burning of a mine tipple and part of a shaft causing a shut-down for a period of two months curtailing severe losses, an unusually severe influenza epidemic, lasting four months and causing closing of schools, churches, and public places, a hurricane, a catastrophe in Japan, and a shortage of water.

Events of this nature, designated as calamities, can be accepted as causes of default only to the extent that they can not be insured against If the risk is insurable and the calamity happens at a time when no insurance or an inadequate amount is being carried in anticipation of the hazard, the attitude of the management, rather than the calamity is responsible for the default

Decrease in Sales, Including Collapse of Export Trade and Ineffective Sales Organization

The naming of decreases in sales as a cause of default usually refers to reductions resulting from changes in the demand for particular products or services, changes in their quality or lack of selling organization and effort A corporation can not exercise any direct control over the demand for its product or service at a price which will permit it to continue as a solvent enterprise Not being able to compel consumption, a decrease in sales representing a change in demand is a cause of default. But, when other conditions produce sales reductions, they cause the default and the reduction in sales is merely incidental to their existence. It is clear that a decrease in sales, brought about through the exercise of control by a corporation over the supply of its goods or services, that is, by limiting the supply to obtain a higher price per unit,

which result is not realized, is due to miscalculations by the management.

A loss of sales may be caused by the collapse of export trade Foreign sales are subject to greater hazards than domestic sales due to tariff barriers, fluctuations in rates of exchange, and changes in international relations. Because of this fact, it is felt that export sales are sufficiently beyond management control to make their collapse an independent cause of default. The present international situation abounds with instances of this character For example, motion-picture producers are currently unable to withdraw funds from Japanese banks Yet they continue to ship films, because they fear the confiscation of their balances if they fail to deliver under their contracts.

Little space need be devoted to considering ineffective sales organization as a cause of default. The methods used by a corporation in selling its product, as well as the selection of employees to be delegated with the responsibility of putting the methods into practice, are functions of management When sales decrease or are not realized because of an ineffective sales organization and default takes place, the default is due to decisions of the management

High Operating or Production Costs

The operating or production cost of a business is the sum of prices paid for raw materials, wages of employees, salaries of executives, rent, taxes, insurance, interest on borrowed money, advertising, selling expense and commissions, maintenance and repairs, depreciation and other items An increase in the price paid for any one of these items, assuming no corresponding decrease in another, causes the cost of producing the good or service to rise

Where high operating or production costs contribute to the default of a corporation, they are mentioned as, "the high cost of labor and material," "the greatly increased cost of everything entering into the operation and maintenance of the company's property," "greatly increased cost of railway operation," "high operating cost and taxes," "increases in wages, materials and taxes," and "high labor costs"

Economically, these costs represent payments made by a corporation for the agents of production. We are told the agents of production are scarce, and as a consequence competing producers bid for them. This bidding establishes the prices paid for the agents and the aggregate of these prices constitutes the cost of production According to this concept,

control of the production costs of a company does not reside in the management. Instead, costs are determined by economic forces over which the management exercises no control, except as one of a group of bidders seeking to acquire agents necessary to production From the viewpoint of business practice, however, the amount of the factors of production and the efficiency with which they are used have a decided bearing upon costs of production, and these are matters which are originally decided by the management, although management is not clairvoyant and can not foresee the future course of events. The costs which appear to contribute to default are termed "high" costs A cost may be high when compared with past costs, or with the price obtained for the product or service in the market. The latter sense is that in which the term is used in connection with default. It would have no significance if the business could raise its selling price to the same extent as its costs of production.

A corporation frequently encounters difficulty when attempting to increase its selling price because of a lessened consumer's demand at the higher price or because governmental supervision of rates and fares places a limitation on its authority in such matters. Defaults resulting from circumstances of this sort must be distinguished from those due to high operating or production costs However, the latter, considered in relation to selling price, can be accepted as a cause of default only when the corporation is using the proper amount of agents of production in the most efficient manner.

Operating Losses.

A corporation is subjected to operating losses whenever the total costs of producing its goods or services exceed the receipts from sales This view excludes receipts from other sources. In this cause of default, both sides of the question are directly involved and clearly appear The costs of production are usually concerned with and answerable for debt, fixed charge and general, and the sales account for corporate income

In the preceding analysis of decreases in sales, it was indicated that corporate income from sales depends largely upon the consumer's demand, and further, that a company had no direct control over the demand side of the market for its product But there are other important factors which have a bearing upon sales, such as competition, general, industrial, and local business depressions, and sales organizations and policies All of these conditions have been previously examined, and

some were found to be beyond the control of management, while others were within in it

We have seen that the costs of producing goods or services of a corporation are determined by the prices paid for the agents of production Assuming market prices to be fixed by economic forces, management influence is entirely excluded However, acceptance of the view that the quantity of the agents of production, the variations of the proportion used, together with the efficiency of their use, have an effect upon production costs, gives recognition to the power of management. The acceptance of operating losses as a cause of default is dependent upon the degree to which they are brought about by managerial decisions.

Strikes

A corporation may undergo a reduction in income or an increase in operating costs, as a consequence of strikes among its employees, or among the employees of other companies

The receivership producing the default of the Chicago and Alton Railway was "precipitated by the great falling off in earnings due to the coal strike and also to the further long continued and extra expense due to the shopmen's strike The Company's normal coal traffic is heavy and practically all mines on its lines have been closed since April 1, thus entailing heavy losses in revenue, and at the same time it has been compelled to buy much of its fuel coal from Southern fields which with added freight charges, paid foreign lines, cost it two or three times its former price." In the case of the Kansas City Railways, financial inconvenience was caused by "a prolonged strike causing practical cessation of service for two weeks and impaired service for some months thereafter, accompanied by violence and unusual accidents Its direct cost was more than $1,000,000."

The jurisdiction of a corporation does not extend to the employees of other enterprises. A reduction in income to a point where debts can not be paid because employees of consumers of its goods or service go on strike, makes such action the cause of default

Disagreements between the management and the employees of a corporation culminating in strikes are not rare or unusual industrial phenomena. The fixing of the responsibility for the strike upon the employees or the management can be properly decided upon only after considering the circumstances surrounding each particular case. It is not inconceivable that management may be in error with regard to the posi-

tion taken on the matter involved, in which event it would be liable for any default emerging from the strike Contrariwise, if those in control are entirely warranted in taking their position, and a strike by employees results in default, the strike would be an acceptable cause of default

Interrelation of Named Causes of Default

The events and actions set forth as causes of default by various interested agencies after investigating the affairs of corporations upon whose bonds default has occurred or is imminent, have been classified into two groups, those which are basically ineffective decisions of management, and those with which management is in no way concerned.

Generally, default by corporations on their bonds is due to a number of causes, rather than to a single cause Furthermore, when more than one cause is indicated, they are not confined to either of the groups, but are instead, distributed between both of them For that reason, the conclusion may be drawn that default on bonds by corporations is the consequence of the interaction of conditions and situations, many of which are initiated and fostered by the management

The position which management occupies with respect to the problem of default can not be overemphasized Its importance is dual in nature, involving the prevention of an undesirable business phenomenon on the one hand, and corporate reorganization on the other It seems reasonable that a plan, proposed to effect the reorganization of a corporation, should contain agreements which would ultimately remove the unwanted conditions. The attainment of this objective is promoted when these conditions are recognized for what they really are, and so considered Evidence is not lacking to support the view that too frequently in the past, in attempting to cover up managerial short-comings, interested groups and the general public have been impressed with the idea that the cause of the embarrassment was beyond the boundaries of effective control. In addition to contributing to the probable success of a reorganization plan, a knowledge of causes aids in reaching a decision to reorganize or liquidate and dissolve the corporation.

CHAPTER 42

MECHANICS OF REORGANIZATION OF INSOLVENT CORPORATIONS

When a corporation defaults on its obligations, if there are substantial earnings, or the prospect of earnings in the near future, or even if there is no immediate prospect of earnings and only the ability to pay operating expenses and taxes, the usual practice is to reorganize it. As previously shown, this reorganization may be voluntary by agreement between the stockholders and creditors. Here there is no need for the intervention of the public authorities. In the absence of such friendly agreements, however, events must be put in train to reorganize the company by using the machinery of the courts, first to protect the business until a plan of reorganization can be perfected, and then, after the plan has been agreed upon by the holders of those classes of securities which have a recognized interest in the business, to put the plan into operation.

The first step is to protect the assets from the attacks of creditors. The company owes money, and the debts are due. The process of debt collection is violent, painful, and destructive. Suit is entered, or if the debt instrument contains a confession of judgment, judgment is entered. There is no valid defense, and defense is seldom made. After judgment comes a writ of execution issued by the court, ordering the sheriff to sell the property and apply the proceeds to the payment of the creditors. Such assets of the company as are not subject to a lien, may be attached by the first creditor who can obtain a writ of attachment. This means seizure. The effect of such actions is, first, to paralyze and then to destroy the business. Wages are not paid, supplies may have been seized. Accounts receivable are impounded, and debtors are instructed to pay the claims to the creditors, who have asserted prior claims. Operations stop. Good-will is gone. The business is dead. This is the outcome if nothing is done to prevent it. In the interest of all concerned, something must be done. Since the first bankruptcy law, passed in 1813, where

there is anything to preserve, the procedure of protection and final disposition under the protection of the court has been followed.

Two situations are presented The first, when the business is not worth saving, when its recovery is plainly impossible, the second, when there is life in the body, where it can be revived, and in time restored to health if "due process of law," which will otherwise destroy the institution, is halted, and time is given for an orderly reorganization The procedure in the first case leads up to a sale of the assets, after expenses are paid and the priority of claims is established This is bankruptcy The steps are (1) a petition to the district court, either by the defaulter voluntarily, or by three creditors with claims aggregating $1,000, which is involuntary [1] The court considers the petition—briefly—and issues an order declaring the company bankrupt. In connection with the order, an injunction is usually issued, ordering every one concerned to keep away, to do nothing to interfere with the orderly procedure established by law to liquidate the business

The first step is the appointment by the court of a receiver as custodian of the bankrupt property, until a trustee is elected by the creditors. The receiver makes an inventory of the assets, sells perishable property, and, if necessary, may borrow money for current expenses, even for a limited period, to operate the business. The referee now enters the situation He is a permanent officer of the court He has jurisdiction over the bankrupt. The referee orders the bankrupt to prepare a schedule of assets and liabilities, listing the individual creditors. He then calls a meeting of creditors, at which all the claims are proven. The bankrupt is available for examination at this meeting by creditors, to disclose any information concerning his assets or liabilities which he may possess.

The creditors at this meeting elect a trustee by a majority in number and amount of the claims allowed by the referee Only unsecured creditors, or secured creditors, to the extent that their several claims are unsecured by lien, are allowed to vote The election of the trustee is subject to the referee's and court's approval. The trustee now takes title

[1] In this petition, an act of bankruptcy must be alleged Recognized acts of bankruptcy are as follows A concealment or removal of assets within four months of the date of filing the petition with intent to defraud creditors, transfer of assets to particular creditors with intent to prefer such creditors, permission of a creditor, while debtor is insolvent, to obtain a lien upon debtor's property, a general assignment for the benefit of creditors or the appointment of a receiver or trustee to take charge of his property, admission in writing of his inability to pay his debts

to the bankrupt's property. The referee turns this over to him. The trustee brings suits for the collection of debts due the bankrupt, and as soon as possible liquidates (sells) the bankrupt's estate He may be authorized by the court to continue the business as a going concern for purposes of sale The trustee may accept or reject contracts of the bankrupt, including leases. He may borrow money on the security of the property in his hands. He may surrender mortgaged property to the mortgagee, when there is no margin of value, and at the sale of the property these priorities are recognized, but the pledged property must be sold if the mortgagee wishes to share as a general creditor in the assets of the bankrupt. The trustee, after payment of all costs and expenses, including his compensation, attorneys' fees, and expenses of administering the bankrupt's estate, distributes among the creditors, according to the amount of their claims, each one sharing alike, the proceeds of sale The bankrupt, if no fraud has been shown, and if he has turned over all his property less legal exemptions, is now discharged from bankruptcy by the court, and is free to start again, free of any suits of creditors for unpaid balances of their claims Corporations are subject, just as individuals, to the operations of the bankruptcy law.

Corporation finance, as a distinct body of procedure, until 1933 was not often concerned with bankruptcy While corporations are often put into bankruptcy, the procedure is about the same as in individual bankruptcy. Its object is liquidation. The trustee can carry on the business, but he seldom does When he carries on the business, this is only for a short time, and in order to sell the business as a going concern. Bankruptcy contemplates not the indefinite perpetuation of the business, but its liquidation, and the distribution of the proceeds of sale among the unsecured creditors. Lien creditors take the property on which they have liens Only the residue is available for creditors, and this is not much The average return to unsecured creditors from a large number of bankruptcies, was 8 per cent of the claims. Only a small fraction of companies which fail in business go through the bankruptcy court There is no question of personal reputation or liability involved; no opportunity to start again These are the considerations which influence the individual in going through bankruptcy. It is no advantage to a corporation to clear the slate for a new start Better organize a new corporation under a new name and shed the bad reputation connected with the old one.

Instead of bankruptcy, there has been developed over many years the practice of equity receivership as a preliminary step to reorganization. Here, the court recognizes that there is going-concern value—earning power—to preserve for both creditors and stockholders This value can be preserved within the limits of bankruptcy practice. The trustee can be authorized to carry on the business, pending a friendly settlement with creditors. In fact, the law provides that a composition may be made in the course of bankruptcy proceedings, which, if approved by 75 per cent of the creditors, is binding upon the minority These arrangements, however, are usually made without resorting to bankruptcy The threat of forced composition is used to force unwilling creditors into line. This composition may provide for reorganization without cash payment to creditors They may give the debtor another chance, extend his claims, accept new obligations for those which they hold, even advance money to assist the debtor, all in the belief that he will reestablish his business, and that they will eventually be paid Creditors' committee reorganizations have already been described Voluntary reorganizations of very large corporations have also been discussed These are all forms of composition Ordinary bankruptcy, however, as stated above, in practice, does not contemplate reorganization Whatever the law, the practice is to sell out and distribute the proceeds.

The object of equity receivership, however, is far different. This practice contemplates reorganization. The receiver continues the business, preserves the good-will, keeps together the working force The court enjoins the creditors from interfering with the receiver in the discharge of his duties, which are substantially the same as those of the bankruptcy receiver Meanwhile, the creditors and, if there is substantial stock equity to be preserved, the stockholders, get together on a plan of reorganization under which the business can be continued. After the plan is agreed on, the court discharges the receiver, after all costs, expenses, and receiver's obligations have been provided for, and the property is sold to a new corporation (this was the general rule) by a committee of creditors who have bought it from the court.

The Sale to a Committee

One of the reorganization committees or a smaller purchasing committee is appointed at a conference of parties in interest to buy in the property.

The procedure of sale is illustrated by the sale of new properties of the American Writing Paper Company in 1927. "The properties," said a statement on behalf of the new company, "were knocked down by the special master (appointed by the court) to Charles S. Flanagan and Norbert W Smith of New York, joint tenants and bidders representing the reorganization committee, for the sum of $3,650,000 The total sum realized including a previous sale was $5,560,600." By this sale, title to the property was vested in the reorganization committee with which the bonds of the company have been deposited The price offered may represent the par value, plus a cash sum fixed by the court to cover the expenses of receivership When a minority of the bonds are not deposited the committee may bid only the upset cash price fixed by the court If nonassenting bondholders wish to bid, for example, if 10 per cent of the bonds are nonassenting and compete at the sale, they must overbid the court's price in cash and 90 per cent of this excess amount will go to the assenting bondholders Suppose, for example, that the court fixed $250,000 in cash as the upset price and that the nonassenting 10 per cent of creditors whose claims total $100,000 wish to buy in the property Suppose further that the bid is $1,250,000 The majority bondholders would receive $900,000 out of this amount and the minority would have a credit of only $100,000, which would require them to find $1,150,000 in cash.

On the other hand, if the majority bid $1,250,000—$250,000 for the costs, and $1,000,000 additional—they would receive $900,000 credit and the minority would receive $100,000. This situation gives the majority, if that is large, 80 or 90 per cent of the total, an overwhelming advantage in bidding against a small minority, because of the large credit which they will receive on their payment.

The reorganization committee was now the owner of the property and proceeded to carry out the reorganization plan.

The appointment of a receiver by a court of equity is an extra-legal procedure. The court has no "legal" right to deprive the creditors of their rights. It does this to protect the creditors, to preserve value which bankruptcy would destroy Receivership can, at any time, be superseded by bankruptcy, if the petitioning creditors will file a bond large enough to protect the court In fixing the amount of this bond, which can be as large as the court deems necessary, the court can deter creditors

from filing a petition in bankruptcy. The whole proceeding is a forced, strong-arm affair, in which the end is supposed to justify the means.

Receiverships, in the days when they were in flower, were usually established by consent A framed issue was presented to the court by the debtor corporation. The practice was as follows A federal judge was approached by directors of some corporation which was in difficulty, either in his court-room or privately Accompanying the directors is a creditor of the company.

The attorney of the company informs the judge, to whom, in most cases, he is well and favorably known, that his client, the A. B. Corporation is insolvent, and he produces a creditor as evidence of the fact. The creditor states that the company owes him certain money, and the officials of the company are there present to confirm that the debt is due and that the company is unable to pay it. In the interest of all parties concerned, therefore, the court is asked to appoint a receiver to take charge of the property until a settlement of its affairs can be obtained. The plea is forcibly made that unless the court intervenes by appointing a receiver, the creditors of the company will seize upon its property, and will render it unable to perform its functions. It may be represented that the embarrassment of the company is due to special and exceptional causes, and that, if the court takes the property under its protection, a few months of receivership will suffice to extricate the company from its difficulties. This procedure is known as making out a prima-facie case for the appointment of a receiver

Different Interests To Be Considered

If the judge suspects no fraud in the matter, he forthwith appoints a receiver, first temporarily, until the other parties in interest can have an opportunity to be heard, and afterward, unless good reason appears for discharging him the receivership is made permanent. While insolvent companies do not often present such a complex situation as we have outlined, there are usually at least three conflicting interests to be considered secured creditors, unsecured creditors, and stockholders. The stockholders, it is true, have no claim against the company for money loaned, but they have an equity in the company which will be sacrificed if its property is torn from it. It may happen, for example, that the embarrassment has been caused by the maturing of a note issue which, owing to the condition of the bond market, can not be funded

at that time. Otherwise, the company may be abundantly able to meet its obligations. The stockholders have here an interest which deserves recognition and protection.

Qualifications of the Receiver

The receiver whom the judge appoints is usually an official of the corporation, often its chief counsel. The reason for making such an appointment is that the judge, not being familiar with the operation of a railroad or manufacturing concern, wishes to install one conversant with the business, who can carry it on successfully If he appointed a stranger to the property, it might suffer injury When a receiver is shown unfit to hold this position, or if it can be made to appear to the court that, with a particular receiver in control of the property, bankers will not come to its assistance, the receiver may be removed When large public companies apply for the appointment of a receiver, the court is usually careful that the appointment is acceptable to all interests concerned. President Bush, of the Western Maryland Railroad Company, for example, was appointed receiver of the property of that company On the other hand, in 1893, President McLeod, of the Philadelphia and Reading Railroad Company, who was at first appointed receiver, was later forced to resign, owing to the opposition of banking interests who held him responsible for the failure of the company

Duties of the Receiver

Immediately following his appointment, the receiver assumes possession of the property of the company, under the authority of an order of the appointing court, which usually authorizes the receiver

1 To take possession of the property of the corporation, to keep this property in good condition and repair, and to operate the property just as the corporation operated it, provided either that operation will show a profit, or if it appears that operation even without profit will preserve the value of the property for creditors and stockholders In many cases also, if the receiver finds that the business can not be saved, that the causes of default indicate that its case is hopeless, he will obtain an order from the court to sell the property at the best price obtainable and apply the proceeds, after deducting his fees and expenses, to the payment of debts in the order of their priority Receiverships of mercantile and manufacturing property frequently take this course. If the property is

subject to a mortgage, however, the method of foreclosure is necessary.

2. To receive the income from the property and to apply this income under the direction of the court to the payment of operating expenses and fixed charges.

3. To collect all debts due the company, and to defend all suits to which it may be defendant.

In the performance of these functions, the receiver may employ such counsel or agents as he may deem necessary He must ascertain as accurately as possible the status of the corporation, and make a report to the court He must also make further reports from time to time, and must obtain express authority for any extraordinary action, such as the discontinuance of interest on bonds or the sale of certain property

Why the Receiver Needs Money

In carrying out his duties, it is necessary for the receiver to provide money When he takes charge, he usually finds a large amount of wages and audited vouchers due and unpaid. The property of the company has usually been allowed to deteriorate, maintenance and replacements having been, wherever possible, deferred while the directors are endeavoring to tide over their period of trial. He also finds various issues of bonds whose holders set up a claim to the earnings accruing from the operation of the business There are also claims under leases of property which it is necessary for the company to retain. This situation requires that the receiver should provide a large amount of money at once to liquidate the more pressing claims against the company. He must then take up the question of dealing with the various creditors who may, in the meantime, have brought suit, usually in the court which has taken charge of the property, to establish their various claims In carrying out these duties, the receiver must raise a considerable amount of money.

Sources of Receiver's Funds

He has three sources to rely upon first, such part of the income of the company as is not required to pay operating expenses, interest, and rentals, second, the amount formerly applied to interest and rentals, and third, the use of a form of obligation known as the receiver's certificate. The receivership may have been caused by the inability of the

company to fund or extend an issue of short-time notes. Aside from this, the company may be solvent, able to pay all interest claims. If the property is earning more than enough to pay the fixed charges of the company from which it has been taken by the court, and in case the receiver elects to pay those fixed charges, he can use the surplus income in his hands to defray any proper expenses of the company. In but few cases, however, is this surplus income sufficient for the receiver's needs. He must obtain additional funds. These he gets, in the first instance, by reducing the fixed charges of the company, by simply declining to pay certain amounts of interest and rentals. The creditors are powerless. The property which secures their obligations is in the receiver's hands. They can obtain their interest only by an order of the court. If, in the opinion of the receiver, whom the judge usually supports, the needs of the property require such action, he need pay no interest, and may apply all of the money which would otherwise go to the creditors, to pay pressing obligations. As a rule, however, when interest has been earned, it is paid by the receiver.

Position of Owners of Leased Property

The owners of leased property need not submit, unless they desire, to the forfeiture or reduction of the rentals. The receiver has no title to their property, his possession of it depends upon his carrying out the covenants of the lease under which the corporation secured it. The lessor company, in case the receiver fails to pay its rental, may, at any time, resume possession of the leased property, and may sue as general creditors for any unpaid balance on the rental or for any other damage which they may have sustained. When leases are profitable to the lessee, there is no danger that the receiver will run any risk of losing control of the property. With unprofitable leases, however, this method of refusing to pay rentals which have not been earned has been largely employed. Stockholders in the lessor company, in such a case, are deterred from acting in defense of their rights by the practical impossibility of making an advantageous arrangement for the disposition of their property elsewhere. In few instances, however, does the receiver carry his powers to this extreme. He is usually satisfied to pay interest and rentals where interest and rentals have been earned, and to refuse to pay only in those cases where the property has not produced a sufficient revenue to meet the specific charges upon it.

Receiver's Treatment of Contracts of Company

The same rule applies in the receiver's attitude toward contracts of the company If, in his opinion, it is desirable to carry out these contracts, e.g., for the delivery of coal, he does so. Otherwise, he disregards the contracts which are not the receiver's obligation For the same reason, the receiver can not bind any purchaser of the property by a contract extending beyond the term of the receivership. Up to that date, however, he is liable for his performance of contracts entered into by him up to the amount of the property in his custody.

Disbursement of Revenues by Receiver under Supervision of the Court

The disbursement of the revenues coming into the receiver's hands is made under the supervision of the court appointing him. An illustration of the method usually followed is furnished by the following quotation from an order issued by Judge Lacombe, making permanent the receivership of the New York City Railway.

In the matter of improvements the receivers are fortunately relieved, at least in part, from the burden of devising improvements in the system by the existence of the Public Service Commission.

The receipts from car service will be devoted first to maintenance, including all necessary repairs and replacements. Next in order are certain fixed charges in the nature of rentals and interest falling due on various mortgage bonds of such roads, which by the terms of the leases, the New York City Railway Company has covenanted to pay. It would seem to be to the public interest, because of facility of transfer, that the roads which were being run by the City Railway when receivers were appointed, should be operated as a unit For the present, therefore, the receivers will continue to pay such rentals and mortgage interest.

This will not include the rental of the Third Avenue Railroad which will fall due the last of this month. A clause in the lease of that road provides that default in the payment of any installment of that rental cannot be availed of for six months Long before that time sufficient information can be gathered (and made public) by the receivers to give such enlightenment to the whole situation as will enable the court to deal understandingly with all questions as to payment of all these items of rent and mortgage interest

Before default is made in any case (except the one above referred to and the rental due October 15 to the Metropolitan Street Railway) petition will be filed setting forth all the facts bearing on the question and asking instruc-

tions, and a day will be fixed on which not only the parties to the suit, but all in any way interested (including the Public Service Commission) will be heard as to the most equitable and wisest course to pursue

Until further order, the receivers will, also, if the other parties to such arrangements consent, carry out the arrangement by which the New York City Railway Company operates certain railroads not under lease, such as the Dry Dock, East Broadway & Battery Railroad and the Union Railway.

Receiver's Certificates

To obtain the money required, the receiver usually resorts to the use of receiver's certificates A receiver's certificate is, in effect, a short-term note secured by a first mortgage upon all the property in the receiver's hands. It is true that when the property was in the possession of the company, the title to the property had been vested in a trust company to secure the payment of mortgage bonds By the appointment of a receiver, however, the court takes the property of the company, and while it is in the receiver's possession he can incur obligations which must be met out of the value of the property before it is released. In law, the mortgage and judgment creditors have liens upon the property, which is in fact theirs, and which they are entitled to sell to recover the debt But a receivership is set up under the equitable jurisdiction of the court and is, therefore, *extra-legal,* though not *illegal* While the court holds the property, it will issue no process of sale, nor is any higher court likely to vacate the receivership Therefore the receiver's obligations are also the obligations of the court, and the property will not be released until they are paid. It is in this sense, but only in this sense, that receivers' certificates are said to be first-mortgage obligations.[2]

Effectiveness of Receivership

Receivership in 1933 was a venerable institution. It had stood the test of time It had protected insolvent corporations against the assaults of

[2] The position of receivers' certificates exactly appears in the following order, made and entered on December 29, 1930, by the District Court of the United States for the Southern District of Ohio "Walter N Jones, the Special Master appointed by the Court to sell the properties of the Wayne Coal Company, has been authorized and directed to pay on or after January 20, 1931, out of the proceeds of said properties, the receivers' certificates issued under order of the Court . . . in the sum of $100,000 in priority to any distribution on the first mortgage bonds or to any other lien or claim upon said properties or their proceeds unless exceptions thereto are filed on or before January 10, 1931 "

forehanded creditors who, but for the protection of the court, might have satisfied their own claims by attaching some of the property of the company, at the cost and to the irreparable damage of other creditors and shareholders. The practice of receivership—the petition, the preliminary and final action by the court, the qualifications, powers, and duties of the receiver in his administration of the property, including the settlement of claims, the surrender of unwanted property to the landlord, or the readjustment of rentals, the relations with organized labor—it was a serious matter to strike on a property in the hands of the court—the conditions under which the rights of mortgage creditors could be subordinated to the claims of holders of receiver certificates, and the methods of conveying the property to a new company after reorganization—had all been settled by appellate court decisions Receivership practice was standardized.

But this ancient institution was built upon the sand. It was beyond the law in its very beginning, because it started with a "framed" issue, in order to make a case for the extra-legal (equitable) interference of the court Here was a curious situation. The company, in almost all cases, instigated the proceeding. The officers knew before any one else the danger of creditors' attachments, and yet they could not, of their own motion, without the concurrence of a creditor, appeal to a court of equity, to deprive the creditors of the legal rights of suit, judgment, levy, and execution So they used a subterfuge They produced a "friendly" creditor, and by the admission of his claim as due and unpaid, the creditor was in a position to apply for a receivership. The company joined in the petition, and appealed to the court to take the company property under its protecting wing [3] Everything was satisfactory except the important matter of legality It is a matter for wonder that this practice was allowed to continue so long.

Objections of the Supreme Court to Receivership

At long last, the sin of illegality in the "buildup" of a receivership issue caught up with receivership practice. The Supreme Court of the United States, first in 1924 and then in 1932, had raised serious doubts

[3] In the R H Hoe and Company, Inc, receivership, for example, the company furnished the money to a relative of an official, with which this obliging gentleman, who knew very little about what he was doing, "bought" a past-due claim from a creditor and so qualified himself to sign the petition

as to the legality of equity receivership, so far as the cooperation of the friendly creditor, the indispensable agent in the whole proceeding, was concerned.

In the first case[4] Chief Justice Taft said

> We do not wish what we have said to be taken as a general approval of the appointment of a receiver under the prayer of a bill brought by a simple contract creditor simply because it is consented to at the time by the defendant corporation The true rule in equity is that under usual circumstances a creditor's bill may not be brought except by a judgment creditor after a return of nulla bona on execution.

The warning of this opinion was not heeded The warning was repeated by the court in 1932 [5]

> Ordinarily, a creditor who seeks the appointment of receivers must reduce his claim to judgment and exhaust his remedy at law We have given warning more than once, however, that the remedy in such circumstances is not to be granted loosely but is to be watched with jealous eyes

These opinions could no longer pass unnoticed They pointed to a dangerous situation. The preliminary process of qualifying a petitioning creditor by suit and judgment against the company, which the court said was the only procedure which it would recognize, was the precise course of action which the distressed corporation wished to avoid by the appointment of a receiver If one creditor was encouraged to start suit, obtain judgment, and issue execution, then all creditors could do this, and the devil take the hindmost. The company's assets would be quickly dissipated by attachments and levies. The opinion of the Supreme Court meant that, in order to justify a receivership by qualifying a creditor to petition for a receivership, the company must run the very risk against which the receivership was intended to protect it—the danger that its current assets would be attached, and also its fixed assets, plant and machinery, if not covered by a mortgage

On the other hand, however, the attorneys who specialize in receivership practice could not ignore the warning of the court. At any time, a disgruntled creditor might bring an action to declare invalid an issue of receivers' certificates, or any other contract entered into by a receiver,

[4] Harkin v Brundage, 276 U S, p 36, 1924
[5] Shapiro v. Wilgus, 287 U S, p 348, 1932

or even might restrain the payment of receivers' fees and expenses. The risk was too great.

The Amendments of 1933

Congress, amid the falling leaves of the Hoover Administration, passed an amendment to the Bankruptcy Act, last amended in 1898, which transferred the procedure of receivership to the United States District Courts, sitting primarily as "law" judges, to administer a "legal" proceeding, in which the "legal" rights of every creditor would be fully protected Congress did more. It placed the approval of reorganization in the hands of the same court, and made a plan, approved by the court (after the plan had been also approved beforehand, in the case of a corporation held to be judicially solvent, by two-thirds of each class of creditors and stockholders, and for an insolvent corporation, by two-thirds of each class of creditors) to be binding upon all parties concerned.

Here was apparently a sharp break with past practice. Instead of a petition for a receivership, addressed to a court of equity, there was a petition in bankruptcy addressed to a court of law Instead of a reorganization conducted by creditors and stockholders, through their own committees, and finally presented to the court as an accomplished fact, the court took an active part in the reorganization, and even forced it down the unwilling throats of a dissenting minority.

In fact, however, the methods of 77B, as the amended bankruptcy act is known, differed little from the practice of receivership now generally discarded. A corporation in difficulties, if there is any ground for a claim of solvency, such, for example, as a valuation by the Interstate Commerce Commission, declaring itself solvent, petitioned the court not to be declared a bankrupt, as under ordinary bankruptcy practice it must do, but to be reorganized that it may be placed upon a sound financial basis. If the corporation does not act, three or more creditors with aggregate claims amounting to $1000 may file a petition. The court could either approve the petition or dismiss it, in which case the corporation must answer, either denying or admitting the facts set forth in the creditors' petition. "If the petition or answer is so approved, *an order of adjudication in bankruptcy shall not be entered* and the court . shall, during the pendency of the proceedings under this section, have exclusive jurisdiction of the debtor and its property wherever located . . and shall have and may

exercise all the powers, not inconsistent with this section, which a Federal Court would have, had it appointed a receiver in equity of the property of the debtor by reason of its inability to pay its debts as they mature"

In carrying out these powers, the judge, under the original amendments of 1933 and 1934, (1) might either continue the debtor in possession of the property, subject to the judge's control (this was the usual procedure with large corporations), or he could appoint a trustee to administer the business of the debtor, (2) authorize the debtor or the trustee to issue certificates (receivers' certificates) with such security and priority as may be lawful in the particular case, (3) require the debtor or the trustee to file such schedules and submit such other information as might be necessary to disclose the conduct of the debtor's affairs and the fairness of any proposed plan (of reorganization), (4) *stay by injunction, "pending suits or the commencement of any suits, or the commencement or continuance of any judicial proceeding, to enforce any lien upon the estate until after final decree."* [6]

Comparison of 77B with Receivership

Note that this is about what the court of equity did, with the single exception, and that was a valuable improvement, that the bankruptcy court acting under 77B, might continue the debtor corporation in possession The equity judge appointed a receiver, so could the bankruptcy judge under the title of trustee The equity judge could authorize the borrowing of money, so could the bankruptcy judge. The receiver did nothing of importance without court approval The corporation or the trustee followed the same procedure In important matters under 77B the judge designates a "master," who is a permanent official, to take testimony and make recommendations which the court usually approves For example, at the date of this writing, the Philadelphia and Reading Coal and Iron Company has applied to the district court, which has the custody of its affairs, for permission to borrow $2,500,000 on the security of the inventory and accounts receivable The company also wishes to surrender certain unprofitable leases paying indemnity to the landlord, as the law requires, of three years' minimum royalties. After extended hearings the master has recommended and the court approved, the first of these requests, continuing his investigation of the

[6] Italics the authors'.

lease question. The court immediately approved the master's recommendation.

From the standpoint of maintaining the continuity of operations and the good-will of the corporation, the provision of 77B which allowed the company, pending reorganization, to remain in possession of its property, was an improvement over the receivership method The tenure of the receiver was temporary If a stranger to the business, he must be cautious because he was ignorant Even if he previously held office in the company, and was familiar with its operations, as a representative of the judge he could take no avoidable risks—business administration always involves risks If they are not taken, the business suffers Customers and employees are disturbed by a receivership. It is a break in the routine. They do not know where they stand Competitors are quick to take advantage of this uncertainty and confusion to twist business away from the receiver Again, the receiver's contracts must terminate when he is discharged He cannot, for example, make a long lease of property Such leases must be approved by a new company if a new company succeeds the former owner.

The Debtor Continued in Possession

This situation was remedied, until the amendments of 1938, by retaining the company in possession The court did not interfere with routine administration, but only in important matters affecting the property Routine administration includes the normal sales, production, and collection activities of the company which are essential to its existence and earnings. What the receiver might hesitate to do, or what, if he did do, he might do badly, the officials do correctly as a matter of accustomed routine. For example, a large jobbing foundry, then in receivership, had accumulated over many years a vast number of patterns These patterns were carefully classified and indexed Occasionally a pattern could be used on a repeat order Ordinarily, however, new jobs required new patterns When the receiver took charge, anxious to save money, he shut down the pattern shop, telling the manager to use his old patterns. This brought the business to a standstill Nothing like this could happen when the company is left in possession Again, especially when the business is still profitable, the higher personnel have been much more contented, since the organization was not disturbed. They have not been employed by a temporary court official, the receiver, but by the com-

pany for which they have always worked. Bankruptcy is something with which they have no direct concern They are not required to adjust themselves to a new situation The pay checks have the same signatures. Everything goes on as before. There is less danger than under receivership that valuable members of the organization, irritated and often disgusted by the impossibility of getting things done, will either let down in their work, or leave to take other positions.

The same advantage appeared in relations with customers. Contracts, negotiations preceding contracts, credit, and adjustments of claims follow the established pattern. Competitors still circulate misleading rumors that the bankrupt company will soon be dead, but the effects of these rumors can be more easily counteracted when the company is still very much alive, than when a receiver is in charge of the business.

The 1938 Amendments to the Bankruptcy Act

Although 77B worked reasonably well for a new measure, mainly because it introduced only one important change, the discretionary continuance of the debtor in possession, Congress was not satisfied, or rather, the Securities Exchange Commission was not satisfied. The Commission, after an elaborate investigation, published a report detailing a variety of abuses in a few reorganizations and leaving the plain inference that these were typical These abuses concerned the domination of reorganization committees by investment bankers, the exertion of improper influence in securing deposits, the improper control of the new company after reorganization, in order, again by inference, to secure to themselves the "emoluments" of control The Commission stimulated the administration, of which it was an important arm during the period of "must" legislation, to influence Congress to again revise the bankruptcy act, in order to bring it into line with advanced thinking in this field The Chandler Bill, approved June 23, 1938, was the result It further amended the bankruptcy act with respect to both trusteeship and reorganization.

For economy of space, and since Section 77, which deals with railway reorganization is not apparently of much importance—no reorganization of Class I companies has been made under its provisions—the discussion will be confined to 77B

The first important change concerned the appointment of an "independent" trustee, which was made mandatory in all bankruptcies where

the debts of the petitioner exceeded $250,000 When debts were less than that sum, the debtor, at the option of the judge, can be continued in possession. The trustee must have had no connection with the business, either as director, officer, employee, or attorney, nor can he have an interest adverse to that of the debtor For example, an official of a coal-mining company can not be appointed a trustee of another coal-mining company operating in the same competitive territory. The trustee is under the control of the court and must report at intervals to the court. He has the same powers and duties as those exercised by the equity receiver. The trustee is also ordered to investigate the management of the debtor, to determine if there are any causes of action against officers and directors. The trustee is also charged with the duty of preparing a reorganization plan, for assistance in which the trustee invites the suggestions of security holders Meanwhile the stock and debt have been classified on the basis of lists of owners which must be furnished the trustee by any one who has such lists, including names and post-office addresses. After submission of the reorganization plan to the Securities and Exchange Commission for an advisory opinion, and after hearings for the consideration of objections, if the plan meets the requirements of the act as "fair and equitable" and provides for the protection of the interests of creditors and stockholders, the plan is approved by the judge The judge now mails the plan, the text of his approval, and the advisory opinion of the Securities Exchange Commission to each owner of securities. The judge fixes a time within which acceptances, if they are to be counted as approving the plan, must be received. Reliance for approval is upon the individual investor He is supposed to consider the documents sent to him, and if he believes the plan wise, to give his approval. Like a German election, there is no provision for votes against the plan. Here the investor votes against it by not voting for it Silence is not consent, but negation. After the plan has been approved and sent out, and not until then, unless special permission has been given by the judge, can committees, even if they have been formed, solicit deposits or powers of attorney.

When, as, and if the plan is approved by the holders of two-thirds of each class of claims, in the case of a corporation determined to be judicially insolvent, and in addition, in the case of a solvent corporation, a majority of the holders of each class of stock, the judge declares the plan adopted and "confirms" it.

The final steps in reorganization do not differ materially from the former practice under 77B. Taken together, they are similar to composition with creditors under the established practice of ordinary bankruptcy. In bankruptcy composition, a plan agreed upon by two-thirds of the creditors affected by bankruptcy—the unsecured creditors—is binding upon the minority, and the proceedings are dismissed.

Procedure If the Plan Does Not Go into Effect

There is one final consideration Suppose the plan is not adopted within the period fixed by the judge, by the specified majorities, including any extensions of time which he may grant, or if the confirmed plan is not consummated, by compliance of the debtor with the provisions of the order. We have assumed that the judge has done his part Then the judge shall enter an order, either adjudging the debtor a bankrupt, if bankruptcy was pending when the petition for reorganization was filed, or, if no bankruptcy was pending, after a hearing, shall either adjudge the debtor a bankrupt and direct that bankruptcy take its normal course of trustee appointment, to supersede the reorganization trustee, appraisal, and sale, or dismiss the proceeding, which, of course, means bankruptcy and sale.

The new procedure, in its preliminary stage, is a reestablishment of the old receivership practice in legal form, with very slight changes, the most important being the requirement that the trustee shall have no direct knowledge of the business which he is to manage and supervise, and that he shall prepare a plan of reorganization. Receivers under the old régime often cooperated with creditors in preparing plans and, especially in small companies, often knew little about the business which they received. The "debtor in possession" feature of the original 77B, the most valuable innovation of that measure, has been removed, and the practice is back where it started

And if the plan is not accepted, and real, not simulated, bankruptcy supervenes, the procedure of bankruptcy liquidation automatically comes into play. The property is advertised for sale and is bought in by creditors. If there is any life left in the business, after all this management by trustees practically ignorant of its administration, after the confidence of owners and creditors shaken by the petition may have been further damaged by investigations and law-suits against the management, after the plan has been prepared in the interest of truth and jus-

tice, without the support and cooperation of organized security holders, under the supervision of the Securities and Exchange Commission—if, to repeat, there is something left to reorganize, some residue of earning power, the creditors' committee, instead of sending for the junk dealer, may reorganize

The powers of bondholders to deal with stockholders and unsecured creditors in reorganizations were very seriously curtailed by the decision of the Supreme Court in the case of Northern Pacific Railroad Company v. Boyd, known as the Boyd Case [7] The Northern Pacific Railway Company was reorganized in 1896 The reorganization was controlled by the bondholders and was accomplished by a foreclosure The property was bought in by the bondholder's committee for $61,500,000, an amount $86,000,000 less than the secured debts. It was transferred to a new corporation, which issued $345,000,000 of securities The old preferred stockholders received 50 per cent of their holdings in new preferred stock and 50 per cent in new common stock on paying an assessment of $10 a share, while the old common stock, in return for an assessment of $5 a share, received 100 per cent in new common stock. Unsecured creditors sought to resist the carrying out of the plan, on the ground that it turned over a valuable equity in the property to the stockholders of the old company to the prejudice of unsecured creditors The Circuit Court, however, held that there was no equity in the property out of which these creditors could be paid and that the mortgage bondholders, in purchasing the property at foreclosure sale, could make any arrangement they chose with the stockholders of the old company.

The new company prospered exceedingly and its stock rose to a high figure. Boyd, the owner of a judgment against the old company, brought suit against both companies, attempting to recover the amount of his judgment out of the property, alleging that the foreclosure sale was invalid because it was made in pursuance of a Plan of Reorganization which excluded the unsecured creditors, although the stockholders were allowed to retain their interest. The lower court sustained this contention, and on appeal, the Supreme Court, by a vote of five to four, upheld the lower court

The opinion of the majority of the Court proceeds upon the theory that while the bondholders might have lawfully bought in the property covered

[7] 228 U S, 482—1913

by the mortgage and kept it for themselves to the exclusion of both the unsecured debt and the stockholders, the moment they provided for participation in the new company by the stockholders, even at the price of paying a heavy assessment, the obligation arose to make provision for the unsecured debt which would recognize their priority to the interest of the stockholders.

The prevailing opinion says (p 504)

> The property was a trust fund charged primarily with the payment of corporate liabilities Any device, whether by private contract or judicial sale under consent decree, whereby stockholders were preferred before the creditor, was invalid. Being bound for the debts, the purchase of their property by their new company, for their benefit, put the stockholders in the position of a mortgagor buying at his own sale. . That such a sale would be void, even in the absence of fraud in the decree, appears from the reasoning in "Louisville Trust Company v Louisville Ry.," 174 U. S. 674, 783, 684 (the Monon case), where, "*assuming that foreclosure proceedings may be* carried on to some extent at least in the interests and for the benefit of both mortgagee and mortgagor (that is, bondholder and stockholder)," the court said that "no such proceedings can be rightfully carried to consummation which recognize and preserve any interest in the stockholders without also recognizing and preserving the interests, not merely of the mortgagee, but of every creditor of the corporation . Any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation.

The court then says (p 507)

> The invalidity of the sale flowed from the character of the reorganization agreement regardless of the value of the property, for in cases like this, the question must be decided according to a fixed principle, not leaving the rights of the creditors to depend upon the balancing of evidence as to whether on the day of sale the property was insufficient to pay prior encumbrances.

The court continues (p. 508)

> This conclusion does not, as claimed, require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock If he declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into the just reorganization, could not thereafter be heard in a court of equity to attack it

In the face of this opinion, it is impossible legally to exclude any creditor from the benefits of the reorganization, if the stockholders are allowed to participate The unsecured creditors must be offered some form of security and they can not be forced to pay any assessment as a condition of receiving these securities [8]

The case of Case v Los Angeles Lumber Products Company, decided November 6, 1939,[9] enlarged the rule of the Boyd case Here the debtor's principal asset was the stock of Los Angeles Shipbuilding and Dry Dock Corporation, whose assets were valued at \$830,000, almost all net The debtor owned six other corporations whose combined assets had little value. The assets of three of them had no value. The debtor's liabilities included \$3,807,000 of twenty-year first-lien mortgage bonds maturing in 1944 No interest had been paid after 1929 A reorganization was effected which gave the bondholders preferred stock for their claims and gave the stockholders in common stock 23 per cent of the capitalization The bondholders (out of 1,000,000 shares, \$1 par value) received 811,375 shares of preferred, and the Class A common stockholders, 188,625 shares of common. After receiving 5 per cent non-cumulative dividends, the preferred stock participated with the common in all future dividends, the preferred stock receiving the first 5 per cent, then the common stock 5 per cent, followed by an equal division The preferred stock received first a preference, and afterward an equal participation with the common stock in liquidation. The plan was assented to by 92 81 per cent of the bonds, 99 79 per cent of the Class A stock, and 90 per cent of Class B, although B stockholders received nothing under the plan. The holders of \$18,500 face value of the bonds dissented and brought the matter before the District Court

The court found that the stockholders had no equity in the assets but, notwithstanding this fact, approved the plan The court said that the priorities and the control were preserved to the bondholders, now preferred stockholders, and that the common stockholders had furnished the bondholders, in return for the receipt of 23 per cent of the common stock, certain "compensating advantages" which the court called consideration

[8] Paul Cravath, "Reorganization of Corporations," in *Some Legal Phases of Corporate Financing*

[9] Case et al. v Los Angeles Lumber Products Co, Ltd, *Official Reports of the Supreme Court*, Vol 308 U S, Number 106

1 The stockholders were "familiar" with the business. It was advantageous to retain their interest, also because they had "financial standing and influence in the community" and could provide a continuity of management

2 The bondholders in a voluntary reorganization in 1930 surrendered their right of foreclosure until 1944, by accepting income bonds in an exchange, leaving the stockholders the right to control and manage the corporation until that date. Long and protracted litigation, expensive and of great injury to the debtor, would be necessary to permit the bondholders to foreclose before 1944 The abrogation by the stockholders of the agreement of 1930 was a valuable consideration to the bondholders

3 Bonding companies would not issue surety bonds with bonds outstanding The debtor, in order to obtain valuable government orders, needed these bonds. The value of maintaining the debtor as a going concern, and of avoiding litigation, is in excess of the value of the stock being issued to stockholders.

The decree of the District Court finally came before the Supreme Court, which decided that a plan of reorganization which is not fair and equitable can not be approved by the court even though it has been approved by the percentages of security holders required by 77B.

The court held that a line of decisions, including the Boyd Case, had decided that "the stockholders' interest in the property is subordinate to the rights of creditors, first of secured and then of unsecured creditors," and "any arrangement of the parties by which the subordinate rights and interests of stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial determination " This is a quotation from the decision in the Boyd Case. In another case, the Supreme Court had said in reference to this "fixed principle" of reorganization law—"to the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation." Even when stockholders contribute new capital, the amount of their participation in the reorganized company must be "reasonably equivalent" to the amount of their contribution. In the present case, the Supreme Court ruled that the consideration offered by the stockholders for their 23 per cent interest was not to be recognized. They attempted to force participation on the basis of their "nuisance value" to refrain from litigation of their position, and because of

their "financial standing in the community" and their familiarity with the business. These facts the court refused to recognize. The conclusion was that if the stockholders had no equity in the assets, they are not entitled to receive stock unless they pay for it The creditors come first, and no plan can be approved which gives stockholders any preference over creditors. If they wish stock, let the stockholders buy it with money Threats and influence are not acceptable in payment.

These two cases—the Boyd Case and the Los Angeles Lumber Case—complement each other They furnish a rule which is now recognized by the courts as controlling in all cases of reorganization

The Voting Trust in Reorganization

One more feature of reorganization plans demands attention. The bondholders have controlled the reorganization and have made sacrifices in order that the plan might be successful They insist, as a condition of their participation, that they should receive some guarantee of the quality of the management. The stock of the new company, if placed upon the market, will command a low figure. It may fall into the hands of speculators who may exploit the property for their own benefit The bondholders fear that they may have another default to suffer, another floating debt to take care of. To guard against this danger, it is almost invariably provided that the stock of the reorganized company shall be placed for a series of years in the hands of trustees who will issue to the holders certificates of beneficial interest in any dividends which may be paid on the stock, the voting power, however, remaining with the trustees.

These voting trust certificates, when issued on behalf of large public corporations, are listed on the public exchanges, and are dealt in exactly as are shares of stock. The voting trustees are usually named by the banking firm which carries through the reorganization. They represent primarily the creditors' interest. Their administration has been generally successful and they have materially assisted in restoring to public confidence the corporations for whose management they have been made responsible.

CHAPTER 43

REORGANIZATION OF INSOLVENTS

The reorganization of an insolvent corporation is a settlement of the claims of the different parties in interest on such a basis that the property can be released by the court and again managed as a going concern. It is attempted only in case the prospects of the business indicate that a reorganization will be successful. Otherwise, the assets must be sold and the business ended.

Necessity of Speedy Reorganization

As soon as possible after the receiver or trustee has been appointed, efforts are set in motion looking to the rehabilitation of the bankrupt corporation. The interests of all concerned point to a speedy settlement of its difficulties. As long as a corporation remains in the hands of the trustee, the values of its securities are low, owing to its uncertain future. Those persons whose capital is invested in the bonds and stocks are unable to find purchasers for their investments at fair prices, or to make loans upon these securities with financial institutions. Banks and trust companies which have taken the securities as collateral are, for the same reason, unable to dispose of the collateral except at a loss, even if they consider it expedient to further complicate an already difficult situation by such a drastic action. All interests are, therefore, equally concerned to reach a speedy reorganization of a bankrupt company. Unless an attempt is made to treat some interest unfairly, the operation is quickly concluded and a settlement is reached which preserves the integrity of the business and equitably apportions among the different claimants the losses which have been sustained.

Objects of Reorganization

The objects of reorganization are as follows:

1. To pay off or fund the floating debt.
2. To provide funds for betterments and working capital and to arrange for future capital.

3. To reduce fixed charges within a conservative estimate of net earnings.

Negotiations leading up to the approval of a reorganization plan submitted by the court to the creditors and stockholders are usually conducted by committees or by the attorneys for committees

Committees Self-Constituted

The method usually employed in the formation of these committees is for individual claimants to constitute themselves or their representatives a committee to take charge of a particular class of securities, and to invite the creditors or stockholders to signify their consent to this arrangement by depositing their securities with some disinterested agent, a trust company, or bank. If a majority of the securities are thus deposited, the self-constituted committee becomes representative and is recognized as such by the courts

The powers of these committees are very broad. The committee is vested with the legal title to all securities deposited with it, and is authorized to act in all respects in behalf of the depositors as though it were the directors of a corporation elected for the purpose. The committee has all the powers of owners of the securities, and full discretion as to the methods of carrying out the agreement. The committee is authorized to sell the deposited securities under certain conditions, to employ agents, attorneys, and counsel, to purchase property at foreclosure sale, and to borrow money on the security of the bonds or stocks deposited by them The principal duty of the committee is to prepare a plan of reorganization which, after reasonable notice has been given to the depositors under the agreement with the committee, and failing objection on their part, signified by the withdrawal of their securities, is held to be binding upon them. The depositors assume liability for the necessary expenses of the committee up to a certain amount on each bond or share of stock deposited It is usually provided that the committee may at any time terminate the agreement, and also allow the bondholders to terminate it by a certain vote. The effect of the deposit of securities is to constitute the members of the committee trustees for the depositors; to form, as it were, a temporary corporation for the attainment of certain objects.

The objects of reorganization are achieved by following certain general rules, based upon legal rights and expediency Cash is needed to

pay trustees' expenses, for distribution to creditors in part payment, to make immediately needed repairs and improvements, and to pay accumulated taxes If the trustee has accumulated cash, either out of earnings or by the sale of trustees' certificates, this can be applied to court expenses and the balance turned over to the company. If the trustees' cash is not sufficient, the money must be obtained by subscription, either from security holders benefited by the reorganization, or from outsiders There are no "assessments" upon stockholders, a device formerly employed. By this method, the stockholders pay an "assessment" of $5 or $10 per share under the penalty of losing their interest in the property, by a judicial sale, to creditors who must then "assess" themselves to provide the necessary money. In return for this "assessment," the stockholders receive shares in the new company which, as explained in the previous chapter, purchased the property of the defaulting company from a committee of creditors who had purchased it from the court. The distribution of shares is usually on a share-for-share basis. This is a forced subscription to stock in a new company. The price of the stock is the amount of the assessment Of course, holders of full-paid stock are not liable to assessment. Subscriptions are underwritten to make payment certain.

Early in the century the practice of giving bonds or preferred stock for the "subscription" grew up, and soon became standard practice. The same compulsion applied, but the common stockholder, for example, who subscribed received shares of new common stock corresponding to his holdings in the dead company and preferred stock or bonds in the new company. This change, from the standpoint of the stockholder and/or unsecured or junior creditor, was an improvement If stockholders will not provide the money, then creditors must provide it by subscription to new securities If creditors refuse, then outsiders must come in, either to purchase bonds secured by first mortgage, to which end existing first-mortgage bonds must be subordinated to the lien of the new bonds, or by the sale of stock on favorable terms to outsiders who see the prospect of profit.

The reduction of fixed charges must deal with rentals, and/or interest. The trustee may have surrendered property held under lease, or he may have secured a reduction of rentals, or he may have allowed unpaid rentals to accumulate, taking the risk of eviction. The court's injunction does not extend to eviction proceedings by a landlord In the

reorganization plan these leases may be fully recognized, in case the leased property is valuable, or the rentals may be reduced, or the property may be surrendered. The landlord, so far as his claims for unpaid rentals are concerned, is an unsecured creditor. If he repossesses the property he can still establish his position as a general creditor. Another method for dealing with the landlord is to give him bonds for his rental claims with or without cash

Unsecured creditors, aside from landlords whose property is necessary to the reorganized company, are in a weak position. Their assent is necessary, but they have difficulty, aside from the power of veto, in establishing their claim to much consideration. If the property is finally sold by the court, and that dread possibility is always lurking in the background of the negotiations, general creditors will lose. They must bid cash, while secured creditors, as we have shown, pay a large part of their price at which the property is "knocked down" to them in their bonds secured by a lien upon the property. Junior lien (second-mortgage bondholders) are in the same position. This inferiority of bargaining power generally results in a conversion of these claims into preferred stock. The unsecured and junior creditors take the best terms they can get. Principal and interest is converted into stock, and fixed charges are correspondingly reduced. Sometimes unsecured bank creditors have sufficient influence with the committees and the court, either by threats or promises, to force special concessions

We come finally to secured creditors, senior lien creditors These are "recognized" in the new set-up according to the value of the property which secures their bonds, to the reorganized company, measured by the extent to which their interest has been earned during bankruptcy. Or, in the case of collateral trust bonds, the market value of the collateral, or if the collateral is stock, the value to the new company of the voting control over markets, raw material, or traffic which possession of the stock carries with it. Recognition of senior securities in the plan finally accepted may take several forms. (1) The bonds may be undisturbed. (2) The principal and/or interest may be reduced In the case of reduction of interest or principal, compensation for the sacrifice may be given in the form of a cash payment, or in stock payment, or both. (3) Bonds may be converted into preferred stock with or without common stock in addition (4) Bonds of whatever grade, of early maturity, must be converted into longer term bonds or into stock.

We have now to consider the application of these rules of reorganization in the working out of reorganization plans.

The Plan of Reorganization

In preparing a plan of reorganization, the first step is to determine what there is to reorganize, what are the earnings of the bankrupt property, and in the light of the visible future of the industry and the company, what will those earnings be The plan, if it is to be successful, must reduce charges, if necessary reduce principal, and postpone early maturities. Default was caused either by unpaid interest or principal or by non-payment of rent. These must be paid out of earnings The plan must provide for a safe margin of earnings over charges if the work of reorganization is not to be repeated.

The record of the past and the earnings of the present are known. The future is obscure Certain facts are, however, available from which the future earnings can be determined The first is the condition of the industry Is the demand for its product or service expanding or declining? This point has been already discussed in connection with the functions of new capital and the causes of default. When a plan of reorganization is being drawn up for a company in a given industry, the state of the industry, as expanding or declining, is of great importance. Upon this determination depends the type and amount of securities to be issued, the sacrifices which creditors and stockholders must make under the plan, and the amount of new capital, if any, which must be provided. During the nineties, many railway companies were reorganized These reorganizations fully recognized the contractual rights of creditors and stockholders. These reorganizations, with very few exceptions, were successful, not because of any special skill or knowledge of reorganization committees, but because the trend of railway earnings, even during the depressed period, 1893-97, when most of the reorganizations were accomplished, was upward. After 1897, this upward secular (long term) trend of railway earnings continued for twenty years. The railway reorganizers of that distant period refused "to sell America short." They had faith in the future. They knew that railway defaults which made reorganization necessary were not due to permanent causes operating upon the demand for railway service With good management and ample capital, for which the reorganization plans provided, it was reasonably certain, in their opinions, that very liberal conditions offered to all

interests would be justified by results. And so it proved to be. The following large railway companies, reorganized during the nineties, paid dividends for twenty years or longer, between the dates when the reorganization plans were declared in effect and 1930.

Name of Company	Date Reorganization Was Effective	Average Dividends on Common Stock Amount in Percentage to 1931 Inclusive
Atchison, Topeka and Santa Fe	1895	6.2
Baltimore and Ohio	1897	4.9
Northern Pacific	1896	6.5
Norfolk and Western	1896	6.6
Reading	1896	6.7
Union Pacific	1897	8.8

Other companies—Erie, Wabash, International and Great Northern, Wheeling and Lake Erie, and Southern Railway among them—did not make such good showings. They did, however, in all cases, pay interest and for periods, preferred dividends, with occasional dividends, in most cases, on their common stock

A different showing was made by railway companies reorganized after the World War. Seaboard Air Line has been in bankruptcy since 1929 Chicago, Milwaukee and St. Paul was reorganized in 1926, and went into a second bankruptcy in 1935 Chicago, Rock Island and Pacific, reorganized in 1916, again fell into bankruptcy in 1933. These companies did not recover their positions after reorganization The advance in railway traffic and earnings had ceased There was no opportunity to accumulate reserves to make their financial positions secure. When the great crash came (and for the Seaboard Air Line before the depression) these three companies collapsed, along with other companies, such as the Chicago and Northwestern, and the New York, New Haven and Hartford, which had paid dividends all through the depression of the nineties.

At present, over one-third of the railway mileage of the United States is in the hands of bankruptcy trustees. Reorganization plans are being incubated As yet few of these plans have been approved But all of them recognize in their terms the fact that the railway industry is de-

clining. Fixed-interest bonds, no matter what the priority of their lien, must reduce principal and security. Stockholders' *nominal* rights are either severely scaled or altogether eliminated The metropolitan electric railway industry has been declining since 1917. Many companies have been reorganized These reorganizations have made severe reductions in fixed charges, and in recognized stock equities.

While reorganization managers and supervisors do not formally recognize that entire industries rise and then decay, the reorganization plans which they sponsor give full recognition to this outstanding fact. Actions speak louder than words.

Having fixed the status of the industry and the company as expanding or declining, the next step is to determine the amount of cash capital which must be provided. Here the task is simple In few cases since 1931 has it been necessary to provide cash. Trustees have borrowed very little. Defaults in interest have been almost total. Cash has been provided for replacing deferred maintenance at the expense of creditors. As these creditors had received large interest payments literally *out of the properties* which were supposed to secure their bonds, so they have been compelled by the courts to put back, on a very large scale, this honestly purloined money by the deferment of interest The provision of cash in recent industrial and railway reorganization plans has been so small as to be negligible. Court expenses, such as compensation of trustees, have been paid out of current receipts In some cases, Philadelphia Rapid Transit, Fiske Rubber, and Paramount Motion Pictures, for example, the trustees or the debtor in possession, had accumulated cash reserves ample for all purposes No doubt, also, the depressed condition of these large industries in which many reorganizations have occurred, and the general feeling of uncertainty which has characterized the investment markets, due among other causes to the burden of taxation, is largely responsible for the failure of reorganization plans to provide large amounts of cash It has usually been impossible to sell the securities of bankrupt companies Only when the margins of safety were very wide and the amounts borrowed small, was new financing possible.

Dismissing the matter of cash provision, the reorganization managers—now the bankruptcy trustees—with the assistance of state and federal commissions, the advice of the Securities and Exchange Commission, and finally with the assistance of committees, proceed to the next step in placing the bankrupt corporation on a sound (solvent) basis

In the chapter directly preceding, the present legal status of the reorganization process has been described. It is intended to be a reorganization without judicial sale. The plan is drawn up and submitted for approval to creditors and stockholders, providing the court or commission finds that stockholders have any substantial equity. If two-thirds of each class of creditors and a majority of each class of stockholders approve the plan, the court, in the same manner as followed in effectuating composition agreements between a bankrupt and his creditors, "promulgates," that is to say, puts the plan into effect. The former method, it will be recalled, was a purchase by a group of creditors, for resale to another corporation formed to purchase from the selling committee, who receive securities of the new company in payment, and the distribution of the new securities among the creditors and stockholders of the old company which the new company supersedes. The district judge, acting in accordance with law, approves the plan and declares it in effect. The trustee is discharged from custody of the property, possession of which he surrenders to the company. The court, in putting the plan into effect, can use the method of judicial sale to a committee of creditors, but this is not often necessary. The possibility that the court will take this step, which might destroy the equity of the junior creditors, is always present in the creditors' minds. It serves to moderate their demands for greater consideration in the distribution of securities than is warranted by the value of their interest in the business.

If and when the plan is approved by two-thirds of each class of creditors, and a majority of each class of stockholders, the judge orders the holders of the securities recognized in the plan to turn them in to a designated depository, and receive the securities and cash which the plan gives them. Dissenting minorities are powerless to interfere. It is no longer necessary to wipe them out by a foreclosure sale, or to force their consent by the threat of a sale. The judge attends to that matter. He continues the injunction, originally granted to protect the trustee against interference, by any one, with the trustees' duties, to protect the corporation which is again in control. No minority creditor can effectively, that is legally, protest. If he starts a suit to obtain the letter of his bond, he will be in contempt of court. He can appeal from the District Court to the Court of Appeals, against the promulgation of the plan. Such an appeal means a heavy bond and large legal expenses. It is not

often practical. The minority creditor, through his attorney, may vocalize, but he must submit

We now return you to the reorganization studio, where the trustee and his advisors are making out a plan What shall be done with fixed charges? What new securities shall be issued? What priorities shall be recognized?

One consideration must be kept in mind. The new laws aim to protect junior creditors and stockholders They are given the veto power as long as the court will not proceed to the summary action of ordering a sale No plan can be approved by the judge unless they vote for it. It must be fair and reasonable to them or they can refuse approval. So what? Unless the senior (lien) creditors approve the plan, and they are not obliged to approve it, the court can not act under it The reorganization is stymied. It can not proceed In turn, the judge may tire of the matter and appoint a master to sell the property At this sale, the lien creditors control the situation They can buy the property and reorganize as they see fit, excluding junior creditors and stockholders from all benefits, taking everything for themselves So the lien creditors, in the final analysis, control the plan, and the junior creditors and stockholders must "bow way down" and take what the senior creditors are willing to give them

At the same time, the senior creditors are not anxious to acquire the property, even if they will not be obliged to provide money for repairs and new construction. Hitler was not anxious to make war on England, if he could have obtained his demands without war Financial interests are much tangled. Junior securities are often held by large institutions and by important personages If the demands of senior bondholders are too severe, they will make enemies The consequences of enmities are unpredictable Senior bondholders in one situation may be junior bondholders in another Holders of first-mortgage bonds on one section of a railway system may come into conflict with holders of general mortgage bonds secured in part by a first lien on another section, from which the section first mentioned derives a large amount of traffic Foreclosure in one case might lead to foreclosure in another German bombing of English cities is offset by English bombing of German cities. Every one loses, no one gains This is on the authority of Herr Hitler, in a statement addressed to President Deladier of France

Again, there is the powerful ally of delay, fighting on the side of the

junior interests. Senior bondholders wish the entire matter settled. They may be receiving some interest, but it is irregular, liable to interruption by conflicting claims, liable to cancellation by a change in the earnings of the debtor company The condition of the property and business may be deteriorating. Delays are often dangerous The veto power of the junior creditors may be effective to prevent any drastic measures

Since debt caused the default, debt must be reduced This is fundamental. How much must it be reduced? If the interest of the company was the sole consideration, the plan would eliminate debt The reorganized company would have no bonds. One plan now under consideration for the Cincinnati and Lake Erie provides for the issue of only one security—common stock The secured creditors receive the largest amount, general creditors a small allowance, and common stockholders receive the least Here the fact is recognized that creditors have a property interest in a corporation superior to, but not in fact different from, the interest of stockholders and unsecured creditors In the plan, the relative position of each class is reflected in the three allotments of common stock. This plan is unusual, but it is to be recommended It presents the simplest desirable capital structure. It avoids the complications of senior securities It recognizes priorities It leaves the future credit position of the company open and improves its present credit standing Tri-Utilities and Midwest Utilities were reorganized with only common stock

A common method employed for dealing in a reorganization with claims of different priorities, is to use two classes of stock, preferred and common, using no bonds. In the Fisk Rubber Company reorganization, for example, $7,260,000 of bonds received 22,860 shares of six per cent cumulative preferred stock, 3 shares per bond, 228,600 shares of common, 30 shares per bond, and 15,240 shares of stock in a real estate company, to which certain properties of the former company were transferred for eventual liquidation. The bondholders received all the stock of the real estate company. Notes amounting to $8,199,500 received 16,399 shares of preferred stock, 2 shares per $1000, and 163,990 shares of common stock, 20 shares per $1000. Other claims, $100,000 in amount, received 200 shares of preferred. In the distribution of securities, the common stockholders were not recognized. Instead, they were allowed to purchase new common stock at $2 50 per share In addition, cash distributions were made as follows Each bond

received $400, each note $370, and each $1000 of other claims, $370 in cash The money contributed by common stockholders was a token payment The price was nominal and the amount realized was only $750,000 out of $9,209,588 cash resources, net current assets, as of June 30, 1932 The reorganization was declared effective in May, 1933 Debts were eliminated, and two classes of stock, plus cash, were used to satisfy the creditors The receiver, in a statement recommending acceptance of the plan, had the following to say "There is no present or reasonably early possibility of selling the property and business as a going concern to outside interests at any reasonable price. If the business is to be liquidated, the amount of provable claims against the unmortgaged assets will (may) be increased, and large expense and prolonged litigation will, in all probability, be unavoidable. It is to be noted, also, that the considerable time necessary to liquidate will inevitably delay any cash distribution to creditors."

It was no surprise that the plan was accepted by creditors. The lien creditors received $2,904,000 of cash and the unsecured creditors, $3,033,630. The new preferred stock paid regular dividends and was eventually retired when the assets were sold in 1939 to the United States Rubber Company for the assumption of all liabilities, $6,827,330 25 in cash and 109,981 shares of United States Rubber common stock, selling at that time for $40 per share The creditors, counting the first distribution of cash, received for $15,559,000 par value of claims, $23,497,000, in addition to a total of $28 50 on each share of preferred stock during the time it was outstanding The common stockholders received $17 47 at its market value for stock which had cost them $2 50. This was a reorganization controlled by creditors, into which common stockholders were admitted, however, on very reasonable terms which showed a large profit to creditors, and, on the actual situation, a profit of nearly $15 per share to stockholders

The Fisk reorganization shows the improvement in the position of the stockholders which has been made by the various amendments to the bankruptcy act. This reorganization was made under the old receivership practice The stockholders took what they could get. They had no voice or veto in the matter. They had no means of knowing that United States Rubber would buy their property and give them such a substantial equity

Had the reorganization been undertaken under the practice laid down

in 77B, as amended by the Chandler Act, the plan would have been perfected by the trustee, with the advice of the Securities and Exchange Commission. The Commission, since it was organized in the interest of those needing protection, would probably have discovered some equity for the common stock. In fact, on the basis of 1930 figures, the common stock had a substantial equity. The company was not insolvent. The book value of its assets was far above its debts The commission might have recommended, in view of this equity, that the common stock be left where it was. There might have been no foreclosure The common stockholders, by their veto power and with the large cash distribution available for the creditors, might have forced more favorable terms. At any rate, it is unlikely that they would have been required to pay anything As it was, under the old procedure, the creditors controlled the reorganization, and took for themselves what there was reason to believe was the entire value, present and prospective, of the company's assets

We come now to the method still in vogue in the reorganization of railroads and public utility corporations, the reduction of fixed charges by (1) reducing the amount of debt, and (2) by exchanging fixed-interest bonds, either in whole or in part, for income bonds In either case, compensation is usually given to bondholders making "sacrifices," in the form of preferred stock. A reason for this type of reorganization, which is sharply contrasted with that usually employed in reorganizations of industrial corporations, is the fact that institutions and trustees are large holders of these bonds They are reluctant to advertise their mistakes by agreeing to accept stock of any kind for bonds In one case, the insistence upon bonds was motivated by the fear of certain trustees that they might be held personally responsible if they did not obtain bonds, preferably mortgage bonds, on some basis of exchange for their present holdings A savings bank or life insurance company is reluctant to take stock into its portfolios No class of stock can be purchased by savings banks, and life insurance companies, in the larger states whose laws control the investments of all companies who wish to sell insurance in those states, can buy preferred stock only if it meets stringent tests of dividends paid It is true that these institutions which accept stock in a reorganization are not obliged to sell the stock at a loss. In practice, they can and sometimes do hold it indefinitely Appearance of stock in a portfolio, however, is a constant reminder of "grave errors of judg-

ment." Income bonds or adjustment bonds look much better and are generally preferred. Industrial bonds are more generally held by individuals who are not so sensitive as trustees. There is also the old prejudice against industrial bonds, and in favor of industrial preferred stocks, to explain the more realistic attitude of industrial bondholders in reorganizations. And finally, to explain the insistence upon bonds in these railroad and some classes of utility reorganizations, there is the unwillingness to recognize that these industries are declining, that only a miracle can save them, that companies in declining industries are in no condition to assume fixed charges, that, if they are to survive and again prosper, they must make radical changes, either in their plant, service or product, and that to these ends large amounts of cash are necessary. A recognition of these facts is very difficult Railroads will not accept the fact that gasoline traffic is leaving them for the pipe-line, that the truck and the fast steamship are rapidly reducing their traffic, that even their mainstay, bituminous coal traffic, has been reduced and is further threatened by the central power station, the Diesel engine on land and sea, and the greater economies of combustion in stationary power plants If railway managements will not face these facts, how much more reluctant are railway bondholders to face them

The best pattern of reorganization is common stock This is the simplest and most flexible capital structure. Next in order of excellence is preferred and common stock In the Fisk Rubber reorganization we have seen how, granted a recovery in earnings, the creditors recover their losses Common stock, granted earnings, is as "good" as bonds. It is often, company by company, much better. General Electric, Allied Chemical and Dye, Monsanto Chemical, International Nickel of Canada common stocks, in point of security of income, are superior to many senior bonds of still-solvent railway companies

Next to a common-stock pattern of reorganization, is a capital structure consisting of cumulative preferred stock exchanged for senior bonds, and common stock exchanged for junior bonds and supplementing preferred stock. Here, priority of claims to earnings possessed by senior bonds is fully recognized. If earnings are available, then preferred stockholders will eventually receive them, together with arrearages of dividend The senior bondholders could get no more, as bondholders, than the preferred stockholders. All this, however, while true, is beside the point. Bondholders of "stable" industries in reorganizations usually demand

bonds. They will make concessions in the character of the claims to interest, accepting income bonds for all or a part of their fixed-interest bonds They will reduce their principal, and accept preferred stock for the difference, but bonds they must have.

A typical utility reorganization plan was that of the Philadelphia Rapid Transit Company, approved in 1940. This company had two classes of creditors—bondholders, with interest charges as of 1936 of $1,751,000, and stockholders of leased underliers, with rentals in the form of dividends of $7,206,000 in the same year It failed to earn its charges in that year by $2,497,000. Its net earnings had fallen from $15,175,340 in 1929 to $8,741,000 in 1936. Its property was in bad condition, due to payment for some years of unearned charges. Its cars and buses were old and in bad repair The company was operating in a declining industry The motor-car had taken away a large part of its traffic. By 1938, net earnings had fallen to $3,750,000. On October 1, 1934 a petition in bankruptcy was filed under 77B as a preliminary to reorganization. For nearly five years efforts continued to reorganize the company. Creditors looked at the substantial net earnings and demanded ample consideration Slowly and reluctantly did they give way One plan after another was filed and one after another failed to gain approval of creditors or of the Public Service Commission or the court The various plans, and the amount of interest-bearing securities provided by each plan, are as follows

	Date	Bonds	Preferred Stock	Common Stock
First Plan	Dec. 1, 1934	131,109,000	7,000,000	35,996,000
Second Plan	April 1, 1937	59,000,000	12,000,000	62,000,000
Third Plan	Dec. 1, 1937	40,000,000	10,000,000	50,000,000
Fourth Plan	Nov 15, 1938	31,974,000	12,301,000	40,799,000

The preferred creditors were the lessor stockholders of the leased surface lines Their annual return, fixed in the contracts, including income taxes paid for the lessor companies by the Philadelphia Rapid Transit Company, the lessee, were $7,900,000. In the plan finally approved, the fixed annual return to the underliers was reduced by $5,900,000, and income taxes, by the conversion of guaranteed stock into bonds, (interest pays no income tax) were reduced $500,000 per year. The bonds given to the underliers were issued by a new

company, the Philadelphia Transportation Company, in the amount of $40,000,000 On these bonds 3 per cent was a fixed charge, and 3 per cent was a charge payable if earned. In addition, 343,500 shares of participating non-cumulative preferred stock were issued to the underliers, and $7,700,000 of cash on account of unpaid rentals. To the holders of the $1,897,860 first-mortgage bonds of lessor companies, an equal amount of first and refunding mortgage bonds, senior to those just mentioned, were issued. The $10,000,000 first-mortgage bonds of the Market Street Railway Company, rented to the P R.T for $1 plus interest, since all the stock was owned by the P R.T., were not in default and were assumed by the new company. The holders of the 280,000 shares of 7 per cent cumulative preferred stock, $3.50 per share, of the old company received 140,000 shares of new preferred stock, $1 00 per share, with participation with the common stock after the payment of $1 00 per share on the 720,000 shares of common stock, in any further dividends up to $1 50 per share This common stock, 720,000 shares, was issued, 579,926 shares to the holders of common stock of the P.R.T., and 140,000 to the holders of the original 7 per cent preferred stock.

The reorganization of the P.R T into the Philadelphia Transportation Company was a realistic performance, imposed upon unwilling rental creditors by the logic of events with the pressure of the court and the Public Service Commission The rental creditors resisted stubbornly. They fought a rearguard action. But they finally accepted terms which gave them less than one quarter of their original demands of bonds, and less than one-sixth in the form of unconditional interest of the amount of rentals which had been paid them for forty-two years. The new company emerged with $6,000,000 of cash. The common and preferred stockholders are recognized, although the stated preferred dividend has been cut from $3 50 to $1.00 per share The position of the common stockholders has been improved in the new company.

Here is a reorganization which recognizes facts and accomplished objectives indicated by those facts Earnings are down, very far down. By reducing taxes in the manner indicated in the plan, replacing obsolete car and bus equipment by modern rolling stock, making up a large amount of deferred maintenance of track, and so placing the track in good operating condition, and abandoning trackage on some routes in favor of buses and trackless trolleys, the new company, it is estimated, can, by lower operating costs and increased revenue from the new equip-

ment, increase net operating revenue by $2,200,000 per year[1] An estimate of $6,000,000 as the minimum earnings of the Philadelphia Transportation Company. This will be divided as follows

Interest on bonds	$2,700,000
Dividends on participating preferred stock @ $1 50 per share	423,000
Available for common stock dividends	2,877,000
	$6,000,000

Even if this estimate is not borne out by results, the plan is very liberal to common stockholders, and very severe on lease creditors. From $7,100,000, rentals (now interest) are reduced to $1,200,000 fixed interest and $1,200,000 contingent interest Preferred dividends ahead of the common stock will be only $423,000. Shares of common stock, although this is of only sentimental value to the holders, are the same as before. The common stockholders were required to make no sacrifices, to advance no money

From the standpoint of the company, the plan is very satisfactory Solvency, at least for the proximate future, is assured. Earnings must decline to $2,700,000 before interest payments are endangered Without allowing for any increase in earnings from the completion of the rehabilitation program, there is a margin of safety for the bonds—and so far for the company—on the basis of the last annual earnings of $2,800,000.

The lease creditors, on the face of the plan, made great sacrifices. These guaranteed stocks of the lessor companies had been regarded as gilt-edged investments, rating aaa in Moody's Estates and institutional investors were glad to hold them. On the $89,434,600 par value of the guaranteed stock, the owners had received for many years a return of 7.9 per cent. These companies owned or leased the surface lines. The P.R.T. was only a sub-tenant of a sub-tenant, the Union Traction Company. The P.R T. owned the equity in the Market Street Elevated Electric Railway, subject to a $10,000,000 mortgage, the equipment (almost worn-out) in the barns, and the parcels of real estate and leases of the Frankford Elevated and Broad Street Subways. The lessors owned the tracks and the franchises, without equipment, and without subway con-

[1] From an unpublished study by Edwin B Meissner, Jr., Assistant to the President of the St Louis Car Works, 1940

nections The company could earn only about half its fixed charges By defaulting on rentals, the court-appointed trustees had accumulated $9,000,000 and had paid substantial sums from time to time on account of rentals As a matter of equity, a substantial share of this $9,000,000 belonged to the underliers.

As for the stockholders, preferred and common, of the P R T, they or their predecessors had paid cash for their holdings. This money, and additional money borrowed, had built the property and purchased the equipment. The underliers had contributed little, although, as already shown in Chapter 37, the Union Traction Company had given at times substantial credit assistance The original tracks had been replaced. The equipment and real estate was owned by the P R T., together with the equity in the Market Street Elevated. Two subways were owned by the city and leased to the P R T In equity, the P.R.T. and its stockholders were entitled to the most generous treatment

These matters of business rights are not, however, settled by equity Bankruptcy is a matter of law The underliers, in law, were entitled to evict the tenant and repossess their property. They had their rights, and they could enforce those rights. As Portia said, "The law allows it and the court awards it" In re Shylock, however, "justice and thy bond" would have led to unpleasant consequences to the creditor And so it was with the landlords of the P R T *De jure*, their position was perfect. *De facto*, however, it could not have been worse The surface railway property was in bad condition due to the payment of underliers' dividends in years past The P.R T. owned all the equipment, both cars and buses, also the car-barns The operating force worked for the P.R.T. and, through their union, owned a controlling interest in its common stock Suppose the lessor companies had evicted the P.R T from their property. They could then have obtained a judgment for unpaid rentals Under this judgment they could have laid claim to the movable property, and at least a part of the cash and the unmortgaged real estate of the P R T in the hands of the court. It is one thing to establish legal right and, under the existing circumstances, quite a different matter to enforce those rights

The Union Traction Company, the top underlier, must obtain an operating certificate from the Public Service Commission. This body has been highly critical, even antagonistic to the claims of the underliers. To the P.R.T., still in the possession of bankruptcy trustees, the commis-

sion might prefer to grant certificates to operate buses over the streets occupied by the lessor companies, and refuse authority to operate to the Union Traction Company on the ground that it was not prepared to render good service The Union Traction Company might appeal to the courts against the Commission's order, alleging that the exclusive franchises applied to buses. This would require much time, with the outcome in doubt P R T. had spent considerable money on the surface properties. They might set up claims to credits on this account. The cash in the hands of the trustee came from two sources. underliers' lines and subways Traffic is interchanged between these two facilities How much belongs to P.R T. and how much to the Union Traction Company? A long court proceeding might be necessary Meanwhile, the condition of the surface property was bad and growing worse. Large sums would be necessary to rebuild the tracks. The new operators had no money and, in the face of the legal situation, could not raise any money. Many of these guaranteed stocks were not fully paid, and their owners were liable to assessment. But these owners did not wish to pay assessments Transfer privileges between the two systems might have been difficult to arrange And finally, if this were not enough trouble threatening as a result of eviction, the employees of the P R T. owned, through the management, a controlling stock interest in the company, and might have called a strike if their property interest was destroyed by eviction Many years ago, a creditor obtained a body attachment against a fat lady weighing 700 pounds She was appearing in a dime museum. The constable presented the warrant The lady said, "Take me" He didn't take her When the lessor companies' lawyers "suggested" eviction—they never reached beyond suggestions—the P.R T. attorneys said, "Take the property." The lessors did not take it.

Under these circumstances, the lessor companies were helpless If, during the prolonged bankruptcy, earnings had increased, or even had they been maintained, the lessors might have been in position to bargain But earnings continued to decline, and the position of the lessors grew worse As time went on, their claims were progressively moderated, and finally, they settled for $1,200,000 fixed interest in place of $7,100,000 rentals so long paid them A better illustration of the general principle stated at the beginning of this chapter, that sacrifices in reorganization are determined by the comparative bargaining positions of the different interests, could not be found

Reorganization situations are many Methods of adjustment must be varied to fit the peculiar circumstances of each situation. Sometimes, when the outlook is especially promising, creditors receive warrants to purchase large amounts of common stock Large profits have been made out of these calls. Sometimes, as already suggested, first-mortgage bondholders subordinate their liens to the lien of a new first mortgage to obtain necessary money. Bankers with unsecured claims may trade on the need for additional working capital to force special consideration of their claims The R F C has not been backward in asserting its rights. Railway reorganization plans have been long delayed because senior creditors demanded special treatment and stockholders refused to concede that their equity was gone Each case demands special treatment The general outlines are, however, the same. Insofar as a general rule of apportioning sacrifices in reorganization can be formulated, it is summed up as follows. that those should take who have the power, and those should keep who can.

CHAPTER 44

LIQUIDATION

A corporation should be liquidated when there is no longer a reasonable prospect of profit and when a substantial amount can be recovered for creditors and stockholders The majority of business enterprises are doomed to failure from the outset. They are the victims of faulty investigation, bad planning, insufficient capital, and poor management Most of them deserve the title, "The thing that never should have been born," given to the old wizard Zikali, by Chaka, the Zulu Napoleon, in a Rider Haggard novel Like the eggs of the salmon or the spawn of the oyster, the mortality among infant businesses is very great Only a small percentage, it is estimated, grow to a profitable maturity Even if the new enterprise gets on its feet and makes a profit, its active life is likely to be short. An exhaustion of funds and an accumulation of debts through the credulity of sanguine creditors unite to end its existence in bankruptcy Out of bankruptcy comes an average of 8 per cent of debt Such experiences give us little light on the principles and practices of orderly liquidation

Occasionally, however, a company with money enough to survive the experimental period, and producing something which is in line with the trend of demand or a standard product which an emergency such as the World War makes profitable, may make large profits within a short time. Its stockholders, who are often active in the business, may be dominated by that *rara avis*, a conservative business man, so that it resists the two temptations of overpayment of dividends and overexpansion of plant, and accumulates a substantial reserve in cash and securities, paying also modest dividends to its stockholders This condition may continue for a number of years. The successful business may be sold in a consolidation, as thousands of companies were sold from 1898 to 1902, and again from 1923 to 1929, and the fortunate stockholders may sell the securities which they receive and so escape the risks of business. The experience of Eldridge Johnson, who founded the Victor Talking Machine Company and built it up to a large and profitable institution, is a case in point. His business in 1925 was dying on its feet

It had lost approximately $5,000,000 in that year. Its surplus had shrunk from $31,351,000 in 1921 to $122,999 in 1925. Already the funeral baked meats were in preparation, when the Radio Corporation of America in 1926, bought the stock at a high price and saved, or rather restored, Mr. Johnson's fortune. The $28,175,000 which he received for his stock Mr. Johnson promptly invested in tax-free New Jersey municipal bonds, and the R.C A., be it remembered, did not pay a dividend on its common stock until 1937.

Many concerns are not so fortunate, or so prudent. After accumulating substantial reserves out of profits—in the present situation, war profits—they continue their businesses in the natural hope of continued gains and the fixed opinion of their managers that they are great business men who, by their courage, initiative, and ingenuity, have made all this money Then comes the period of decay when liquidation is indicated but seldom effected.

The Kelly Springfield Tire Company was incorporated on April 15, 1899, as the Consolidated Rubber Tire Company. Its plants were located at Akron and Wooster, Ohio, and Buffalo, New York; in 1925 all manufacturing was concentrated at Cumberland, Maryland, one of the worst locations that could have been chosen, and evidently selected by the officers in a moment of mental aberration or overweening optimism During the War and post-War years, when the automobile industry was expanding rapidly, when the quality of tires was very poor and their life-span short, the company made and conserved large profits. Its 1925 balance sheet read

Assets		Liabilities	
Plant accounts, patents, equipment, etc.	$20,077,605	6% preferred stock	$ 2,950,000
Cash	1,699,127	8% cumulative preferred stock	5,264,700
Real Estate, deferred	89,163	Common stock	9,096,003
Investments	32,370	10-year 8% notes	7,000,000
Notes and accounts receivable	4,410,928	Accounts payable	2,460,040
Deferred charges	502,739	Notes payable to banks	750,000
Inventories	8,051,957	Balance due customers	21,475
	$34,863,889	Accrued interest	82,500
		Accrued taxes	254,974
		Premium on 10-year notes redeemed	249,547
		Surplus and reserves	6,734,650
			[illegible]

This company, as shown by the balance sheet, was in a healthy condition. It was retiring its notes at the rate of $1,000,000 a year, and was paying regular dividends on its preferred stock. On January 1, 1926, allowing a liquidation value of only 25 per cent of its fixed assets, the company could have paid off all its debts, retired its preferred stock, and paid $2,404,949 to its common stockholders Of course there was no suggestion of such a course. The year 1925 showed a profit of $1,452,-577 as against a combined deficit of $2,692,034 for the two preceding years. Operations had been consolidated in the Cumberland plant, and the future looked bright. In 1926 came disaster. Let the president explain it His report of March 12, 1927, said

> The year 1926 was one of substantially declining prices of both rubber and tires. In the beginning of the year when crude rubber was selling at about 90 cents a pound, we had on hand and had commitments for less than 4 months supply based on normal business However, the backward spring and summer, together with the necessity of rebuilding many of our sizes, checked sales, resulting in the accumulation of inventory of both finished product and crude rubber, the price of which began rapidly to decline until it reached 40 cents a pound In addition to this, there were three price cuts in tires amounting to 50 per cent
>
> During the year the Cumberland plant was thoroughly reorganized. The changes were sweeping, and during such reorganization it was necessary to cut down production and to rebuild certain sizes with which to replace certain defective goods. All stocks on hand were carefully inspected, and all tires not fully first class were branded seconds and sold as such. This program of necessity resulted in a substantial operating loss for 1926
>
> Based upon the business the company is now doing, the favorable response which the buying public is now making to our products, and the fact that the company is now freed from the causes which contributed to the loss in 1926, the management believes that the business of the company *for the year 1927 will be satisfactory.*

This did not tell the whole story, although it shows a degree of mismanagement that was serious. In order to get through the "reorganization" of its business, the Kelly Springfield Tire Company increased its notes payable to banks nearly $8,000,000 and was in a precarious position Its combined surplus and reserves had fallen to $2,180,889, and it had lost in a single year $3,349,800 The opportunity to liquidate this

mismanaged, badly located, overcapitalized company had disappeared Liquidation would have shown something for the preferred stock, but nothing for the common.

Now the common stockholders, gluttons for punishment, rallied to the rescue. The capital structure was changed In 1927, 700,000 shares of new common stock were authorized and offered to the common stockholders at $21 a share. A portion of it was underwritten for a substantial commission, and practically all of it was sold, providing the company with sufficient cash to pay off all of its bank debt and to retire the balance of its ten-year notes After the receipt of this new money, the current asset-ratio was increased to 12½ to 1, and, as the president said in his annual report, "It is expected that the year 1928 will show further improvement in earnings over 1927, when a profit of $357,741 was earned " Again came disappointment, a decline in inventory values, cuts in prices, and a loss of $2,490,513.

At this point it might appear that the stockholders had lost enough. They had given the management a year's trial. Dividends, of course, had been suspended on both classes of preferred stock since 1924, but the company was free from debt. At the end of 1928 it could have been liquidated, all preferred stock with arrearages of dividends could have been retired, and, still allowing a realization of one-fourth of the book value of the fixed assets, about $10,000,000, or over $40 a share, might have been realized for the common stockholders Liquidation was the move indicated when the miserable showing of the Kelly Springfield Tire Company was contrasted with the profits of other companies In 1928, in the face of all the discouraging circumstances advanced to explain the showing of the Kelly Springfield Company, Goodyear Tire and Rubber showed a net income of $13,327,844, a slight increase over 1927.

But the Kelly Springfield management courageously carried on They had plenty of the stockholders' money and they continued their earnest efforts In 1929, while Goodyear earned $25,003,156, Kelly Springfield lost $4,080,486 Even yet something could have been saved for the stockholders. At the end of 1929, current assets amounted to $12,257,444, enough to have retired the preferred stock Still there was no thought of liquidation The year 1930 told the same dismal story, a loss of $3,796,054, while Goodyear made $14,798,718 With this year the

opportunity for profitable liquidation had faded The harvest was passed, the summer was ended, and the liquid assets of the Kelly Springfield Tire Company had not been saved for the preferred stockholders.

Attitude of Management Toward Liquidation

The experience of the Kelly Springfield Tire Company is typical. Liquidation is usually considered only as a last resort when the company can go no further. The reasons for refusing to liquidate as long as money is available to carry on grow out of the psychology of managers, owners, and creditors From instinct and interest these men are incurable optimists The managers, who are generally large stockholders, have given their lives to building up the business In the case cited, one of the officials literally worried himself to death over the misfortunes of his company. They are now in middle life They draw substantial salaries and they are persons of importance in their communities To admit the fact of failure, to advise the stockholders to liquidate and save what they can out of the dying business, is simply beyond them They can not do it. They cling to the few straws of hope which the rushing tide of business change brings within their reach In their minds prosperity is always just around the corner. Unless forced to give up, they pursue the foxfires of hope until the last dollar is spent.

Another consideration operating on the minds of stockholders, as distinct from managers, is the effect of liquidation upon their holdings. If there are no creditors and no senior stockholders, a long siege of adversity may wear down the stockholders' resistance, and, as many New England textile companies, for instance, have done, they may liquidate Such a situation, however, seldom arises. Even if the original capital structure did not contain senior securities whose principal or par values, with accrued interest and dividends, must be fully paid out of the proceeds of liquidation before junior security holders receive anything, the company has usually issued senior securities, often to postpone the evil day of final reckoning With senior securities outstanding in substantial amount, liquidation would leave nothing for the common stockholder, whom the management generally represents and whose consent is generally necessary to authorize corporate hari-kari. Why then, so long as operations can be continued, should common stockholders consent to liquidation? Everything will go to the bondholders or preferred stock-

holders, who will inevitably demand their pound of flesh, even though they shed the financial blood of the common stockholders in the cutting of it.

Even should a sale of the entire business be made in exchange for the stock of another company, this stock must go to the preferred stockholders of the selling company The National Bellas Hess Company, which was placed in receivership in April, 1932, is an example On July 13, 1932, the name, good-will, customers' list, and miscellaneous operating equipment were sold to a company organized by a number of key executives of the original company for $100,000 cash in instalment form, the assumption of certain liabilities, and 300,000 shares of common stock. After the payment of debts, reserves, expenses, and fees, the remainder of the consideration will go to the preferred stockholders. Without the receivership it would, of course, have been impossible to secure the consent of the common stockholders to such a plan, which gave them no share of the purchase price In 1929 the balance sheet of the National Bellas Hess Company showed net current assets of $8,718,123.

Attitude of Common Stockholders

Why should the common stockholders make this grand gesture of renunciation? Of course they will hang on as long as possible. Unless they default in the payment of some debt, or unless the charter gives the preferred stockholders a controlling voice in the matter, even though common stockholders should be able to coerce a management clinging tenaciously to their salaries and offices, there is no inducement to them to salvage the assets for the benefit of creditors and preferred stockholders. It is better to carry on the decaying business in the hope of a miracle. This situation recalls that most valuable of all preferred stock protections, the provision for the transfer of the voting power when a year's preferred dividends have not been paid. If this had been included in the charter of the Kelly Springfield Tire Company, the preferred stockholders could, had they desired (and of this desire there was, of course, no evidence), have forced liquidation in 1930, when there was still something to be salvaged

Still, for companies in dying industries, and there are many such, or for mismanaged companies in solvent industries, the day of doom finally

arrives. They can go no further Their cash is gone. Their credit is exhausted. The last day dawns. Like the Apostle, they have fought a good fight, they have finished their course, they have kept the faith, but unlike him, they have usually laid up for creditors and owners nothing but the meager fruits of salvage

The methods of liquidation may be considered under two headings First, judicial sale, and second, the realization of the assets of a solvent company

Judicial Sale

The first need not long detain us A receiver may be authorized by the court to sell the property in his hand on the best terms obtainable and as promptly as possible Or the trustee in bankruptcy may follow the same procedure In making such a sale, the trustee or receiver is not limited to cash sales He can accept part cash, with deferred payments secured by such liens as the situation warrants Until these liens are discharged, however, these legal custodians with their retinue of attorneys continue to function at the expense of the bankrupt estate, so that it is usually more profitable for the creditors' committee, whose advice the receiver is likely to follow, to sell the assets for cash as quickly as possible and to turn over to the creditors whose claims he has approved the small balance after expenses are paid.

Here again the inveterate optimism of creditors, continuing so long as a ray of hope remains, often stands in the way of liquidation. The reorganization committee recommends that an earnest effort be made under new management and with new capital secured by a "first lien" upon the assets, and the bondholders fall into line and, by a process of blood transfusion, revive, if only for a little while, the moribund business They accept debenture bonds or preferred stock for their claims, and "carry on"—often only to find that the new money has been thrown away Consider, for example, the case of the Ground Gripper Shoe Company, bankrupt. On May 3, 1932, the committee for the holders of the 6 per cent convertible sinking fund gold debentures and general unsecured creditors said

A consolidated balance sheet of the bankrupt company furnished by the trustees in bankruptcy as of March 31, 1932, treating wholly owned stores and Canadian Company as investments, shows total assets with a stated book

value of $2,689,995, against which are listed actual liabilities in the amount of $4,043,120 . Of such listed assets, however, approximately $1,507,000 are held by the ——— Bank and Selby Shoe Company as against their respective claims, totalling $1,010,581 84, which are assets to be secured. These assets consist of accounts and notes receivable and manufactured merchandise, and . in the event of liquidation of the business such assets could not be expected to realize even a sufficient amount to pay in full such claims for which they are held.... The remaining assets appearing on such balance sheet as at March 31, 1932, totalling $1,183,063.... An analysis of such remaining assets inevitably leads to the conclusion that on forced liquidation only a very small fraction of such values could be realized

In other words, the company is through But the creditors are generous They think that there is life in the carcass, and they are willing to cooperate. The bank, whose record in such matters is one of intelligent generosity, has offered to reduce its secured claim from $800,000 to $300,000, transferring $500,000 to the class of unsecured claims, and the Selby Company has offered to furnish new capital So the committee proposes to the creditors that the company shall be reorganized, that $375,000 of serial debentures and $249,336 of seven-year second debentures be issued. Of these senior debentures, $300,000 are to be issued to the bank, which will then release all the cash notes and accounts of the company held by it, and $75,000 together with the 72,000 shares of common stock, to the Selby Company, in return for the sum of cash necessary to carry out the plan, the amount to be afterwards determined. The creditors of the company are to receive 36,000 shares of the preferred stock The Selby Company hopes to preserve its outlets for its product, and the bank hopes to get a return on its preferred stock Without hope, life could not go on.

When the process of disintegration and dissolution has stopped short of receivership or bankruptcy, a more profitable program may be followed, which may recover for the creditors and stockholders a portion of their investment.

Orderly Liquidation

The business may be sold as a going concern, either for cash or for securities of the purchasing company, a form of merger whose details have been outlined in a preceding chapter A large number of bank liquidations, notably that of the Foreman-State National Bank and the

Foreman-State Trust and Savings Bank of Chicago, which was consolidated in 1931 with the First National Bank of Chicago and the First Union Trust and Savings Bank, have been accomplished by merger. The recent legal troubles of the New York Superintendent of Banking, Mr J. A Broderick, were due to his well-meant and narrowly frustrated attempts to save the Bank of the United States in 1931 by merging it with three other institutions Fortunately for him, the jury before which he was brought to trial on a charge of official misconduct because he did not close the Bank of the United States at an earlier date and because of an alleged laxity in permitting unsound banking practices to continue, gave Mr Broderick credit for good intentions and acquitted him Under the conditions which have prevailed since 1929 a bank merger is likely to be a disguised liquidation.

In some cases a portion of the assets can be advantageously sold and the remainder kept, either for subsequent sale, if prospects do not improve, or, if a miracle occurs, for subsequent profitable operation The writers have recently had called to their attention the situation of a manufacturing company with no debts, $247,000 of capital stock, and $196,000 of liquid assets including $60,000 of government bonds. Last year showed a loss of $13,000, and this year will show a greater loss. Here an immediate partial liquidation is indicated. The directors can make a sufficient addition to surplus by reducing the par value of the outstanding stock in the manner indicated in a former chapter and can then declare a special dividend of perhaps $125,000 out of the current assets, leaving $55,000 of working capital in the company with which to carry on till, if ever, the company is again able to operate at a profit. In this case, from available information, the business offers little promise of recovery, and a complete liquidation of assets is indicated as the wisest course. This, however, is apparently beyond the resolution of the stockholders

The sale of the Triplex Safety Glass Company of America to the Libbey-Owens Ford Company of Toledo, Ohio, is another illustration This company, organized in 1928 largely on the strength of a contract with Ford, in 1930 showed a profit on net sales of $3,525,894 of only $34,075. Its debts were insignificant. Its prospects were gloomy. It had, however, certain valuable patents and had brought a number of suits against infringers. In one suit it had been successful, and a substantial recovery of damages is anticipated from certain large companies. These

patents, therefore, had a demonstrated value in the hands of a strong company like Libbey-Owens Ford, although the Triplex Company, a helpless lamb among the ravening wolves of the glass industry, could not make profits outside of the courts, and in its present condition of desuetude might have great difficulty in proving large damages Therefore, the management of Triplex took wise counsel of its fears and sold its good-will, land, buildings, machinery, patents, and trade-marks, and a substantial portion of its inventory, together with its unprofitable Ford contract, to Libbey-Owens Ford The price was 29,490 shares of the purchaser's stock, cash for the inventory purchased, and $25,000 cash additional The Triplex Company retained all its cash and receivables, its rights to damages in connection with its patent suits, and the stock of the Triplex Products Company, organized to develop certain side-lines

Application of the Proceeds of Sale

In disposing of the proceeds of the sale, the Triplex Company must, under its charter, apply the proceeds first to satisfy the claims of the preferred stock, which was accomplished by purchasing for retirement nine out of ten shares in return for $40 in cash, two shares of Libbey-Owens Ford stock, and one-tenth of a share of the preferred stock deposited for acceptance of the offer The Triplex Company was to be continued as a holding company for the stock of Triplex Products and to receive and distribute the proceeds of the infringement suits. The common stockholders of Triplex would be relieved of the burden of 90 per cent of the preferred stock and, subject to the rights of the remaining tenth, would receive all of the cash receipts of the company from whatever source derived, including the anticipated dividends on the stock of Triplex Products. This was an excellent transaction from the standpoint of both classes of stockholders of Triplex, and particularly satisfactory to the preferred stockholders.

The third method of liquidation involves all of the assets. This may be accomplished in the ordinary course of business by gradually reducing the scale of operations, disposing of unused plants and machinery, and, from time to time as cash permits, paying liquidating dividends to stockholders, creating the necessary surplus if it is not already on the books In such a process the object is not to make a profit but to reduce the losses of forced sale of assets by working up raw materials into finished products and selling these in the ordinary course of business.

In mercantile liquidations it may be necessary with this method to make limited purchases of merchandise in order to keep a full line, the absence of which might repel customers. The inducement of cut prices, the reductions from normal increasing as the end draws near, is also offered, with a final bargain-snatching sale of 50 per cent.

The Gardner Motor Company Liquidation

The liquidation of the Gardner Motor Company illustrates this method. For the year ending December 31, 1931, the company balance sheet showed assets, book value, of $1,185,942 and debts of $7,172. Some of these assets, such as the stock of the Detroit Aircraft Company, had greatly depreciated in value. Being sensible men, the directors, in 1930, began to curtail operations and planned to put the company in as liquid a position as possible in order to take advantage of any situation that might present itself They worked up the stock of parts and materials into automobiles and sold them Then they discontinued production except for the supplying of parts They paid practically all of the debts. They transferred the warehouse to a separate company which was expected to realize $2,000 a month rental, doing also a loan business with capital furnished by the Gardner Company. The directors then passed the following resolutions.

1. That the company discontinue the manufacture and sale of automobiles, and sell its parts department, including the goodwill, patterns, and dies of this department.

2. That the company sell and dispose of all its machinery and equipment

3. That the company reduce its capitalization to create a surplus which will enable it to distribute to stockholders, as a dividend, such cash as, in the opinion of the board of directors, may be advisable in view of the necessity of working capital being retained pending the complete liquidation of the company's assets In the event of the stockholders' approving the reduction of the company's capitalization, the present board of directors propose to authorize the payment, forthwith, of a dividend amounting to 25 cents a share

4. That upon the reduction of the capitalization, and the creation of a resulting surplus, the present board of directors propose to also distribute, forthwith, as a dividend to the stockholders, 30,000 shares of the capital stock of the Detroit Aircraft Corporation now held by the company, on the basis of one share of Detroit Aircraft stock for each ten shares of the stock of the company. For stock holdings of company representing any holding not

evenly divisible by ten, a cash distribution will be made in lieu of a distribution of a fractional share of Detroit Aircraft stock, on the basis of the closing sale price of Detroit Aircraft stock on the New York Curb Market on the date of the record of stockholders for the payment of such dividend

5. The liquidation of the real estate holdings in Cleveland, Ohio, and the sale of the St. Louis plant building and lease, the company carrying on, through its subsidiary, Rutger Street Warehouse, Inc., a general warehousing business, in the interim.

The outstanding capital stock of this company on December 31, 1929, was only $1,500,000 On February 8, 1931, it had in cash $259,653, notes and accounts receivable of $30,208, inventories $51,412, cash in the hands of a trustee $78,794—a total of $520,067, and in addition, its warehouse and aircraft stock, from which in this well-considered process of orderly liquidation, its stockholders may expect finally to receive in total the par value of their holdings. This is an excellent illustration of the truth of the proverb, "The prudent man foreseeth the evil and hideth himself, while the wicked rush on and are punished" There is indeed, as the directors state, "doubt as to future business success for small independent automobile companies," and the stockholders were fortunate that their affairs were in the hands of prudent trustees who could discern both the face of the sky and the signs of the times.

Losses in Bond Value by Forced Sale

There is finally the last form of liquidation—by forced sale at the best price obtainable A recent report to a reorganization committee shows the probable results of liquidation under these circumstances.

The appraisal of the assets in the receiver's possession shows a total of $212,512 97, divided $63,271 to current assets and $149,241 97 to plant and equipment. Analysis of the appraisal shows that only a small fraction of the total "value" of the business could be realized by sale. Taking the fixed assets first, we have the following·

Land, including railroad sidings, piping, etc.	$25,368 22
Buildings	74,637 00
Sprinkler system	18,630 75
Equipment	30,606 00
	$149,241 97

If the business is liquidated, these assets have little value The buildings and land could not be sold for any other manufacturing purpose With the company out of business, the property would not have even a nuisance value to a competitor With the buildings on the land, that would be worthless except for farming purposes, and the farm value would not pay the cost of removing the buildings.

The sprinkler system, carried at $18,630 75, might be sold, second hand, for $1,000, but this is doubtful. Much of the equipment consists of permanent structures—furnaces, ovens, etc., valueless elsewhere, while the movable machinery might bring $2,500 at a forced sale A total value of less than $5,000 is all that could be realized for the fixed assets of the company

Current assets present a better showing. We estimate, allowing for the expenses of the sale, and the difficulty in collecting accounts in second hands, that $40,000 might be realized, over a period, for the current assets, making a total of $45,000 which forced liquidation might produce, or, including half of a frozen bank deposit of the receivers, $7,000, a total of $48,500.

Out of this sum must be paid the following claims prior to the claims of the bondholders

Loan of bondholder's committee	$10,000
Costs and fees of receivership	10,000
Taxes	10,000
	$30,000

A balance of $18,500, or about $50 on each $1,000 bond, is all that could be realized The realization of even this sum assumes a combination of good luck and good management in liquidation Many manufacturing companies in this situation have liquidated without realizing anything for their creditors.

This situation differs from many, although it is otherwise typical of its class, in that there is still a considerable inventory. It shows, however, the small amount that can be obtained for fixed assets and machinery. The rule is a nominal amount for the real estate, unless liquidation occurs during a period of business activity, when the directors, who act as trustees in liquidation, may find some other concern to take up the burden either as owner or tenant. An illustration is the huge automobile plant at Elizabeth, New Jersey. This was completed in 1920 by advances from the Willys Company, a holding company for the automobile interests of John N. Willys. It was reported to have cost $9,000,000. This enterprise failed, and the plant was sold in 1922 to Durant Motor

Company of New Jersey for $5,525,000 cash. Durant carried on operations in a desultory fashion until 1929, when the plant was abandoned for its original purpose and a contract of sale was made for $3,420,000 to the Bayway Terminal Company, purchase to be made at any time within two years from April, 1930. The latter company passed into receivership in January, 1932.

Here the depreciation in value, while extreme, was not total because of the opportunity of sale presented by the prevailing business activity. In contrast, a large textile company in New England in 1931 offered one of its plants for sale, for which ten years before it had refused an offer of $1,000,000, and could obtain no bids The plant was considered worthless When machinery is of standard pattern, e g., in textile operations, it can be sold at a price to second-hand dealers, but a price of 10 cents on the dollar of book value is often all that can be obtained

Liquidation, as a result of the sad experiences of 1930-32, is likely to assume increasing importance. The investor has had impressed deeply on his mind the extreme hazards of modern business, the necessity of retaining ample cash reserves out of profits or original capital contributions, the danger of incurring bank obligations and of issuing fixed, interest-bearing obligations This education in the dear school of experience, in which every one, not merely fools, must learn, is likely to result not only in greater caution in embarking upon untried business ventures, but in greater care in conserving their profits And in particular, when the future is clouded with doubt, will stockholders' representatives be more open to the suggestion of liquidation, even when only half the loaf remains. It is far better than an Irish dividend

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